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INTRODUCTION

Competitiveness, no matter how it is defined, depends on the cost of producing tradable commodities. Accordingly, in this study, we follow Klein’s (1988) approach and narrow the concept of competitiveness to the countries’ ability to sell their products in world markets. We concentrate on issues related to market access and factors determining the average wage rate, labour productivity, profit margin, and the exchange rate. Regarding market access, we note that favourable market access conditions represented by low tariff rates and non-tariff barriers in the rest of the world is an essential requirement for increasing exports. We note, further, that for the country to stay competitive, it should try to hold down its unit labour cost in terms of foreign currency relatively to that of the rest of the world. This may be achieved either through wage restraint, or through productivity enhancement or through a combination of both. Therefore we concentrate on the analysis of characteristics of labour markets determining the average wage level and of determinants of labour productivity.

In the study, following Klein’s approach (1988), the profit margin refers to the mark-up over labour costs and covers the costs of capital, energy and other materials, it also includes adequate returns to risk. Since an increase in the profit margin implies a decline in competitiveness, we study the capital markets and more specifically the role of investment incentive schemes and of taxation policies, in determining the cost of capital.

We further concentrate on issues related to market access and factors determining the real exchange rate. Regarding market access, favourable market access conditions represented by low tariff rates and non-tariff barriers in the rest of the world are essential for increasing exports. The exchange rate is expected to affect exports positively if it increases (depreciation of the domestic currency) and adversely if it decreases (appreciation of the domestic currency).

The study analyzes all of the previously mentioned factors determining the competitiveness in four MENA countries: Egypt, Morocco, Tunisia and Turkey.

The grant approved by FEMISE is used for the funding of three country papers (Egypt, Tunisia and Turkey) on each of the following topics:

I- Trade and Foreign Exchange Regimes
II- Labour Market Flexibility
III- Investment Incentives, Marginal Effective Tax Rates and the Cost of Capital.

Each of the topics will be briefly addressed, focussing principally on methodology, major findings and issues for related future research.

1. TRADE AND FOREIGN EXCHANGE REGIMES

Introduction

This part of the research project aims at identifying the factors and mechanisms of trade and exchange rate policies that determine and contribute to the competitiveness of MENA countries. This is achieved; through a comparative study that includes three of the MENA countries: Egypt, Tunisia, and Turkey; by i) investigating the tariff and non-tariff barriers to trade, ii) determining sectoral nominal protection rate for each of the specified sectors, iii) considering the export subsidy system, and finally by iv) analyzing the developments in real exchange rates, and studying the relation between export performance and real exchange rate and the impact of exchange rate variability.

After sketching, in sub-section 1, the structure of foreign trade in the three MENA countries; sub-section 2 overviews the liberalization policies applied. Sub-section 3 and 4 consider market access issues for industrial goods and agricultural commodities, and for services successively. Tariff height and dispersion are analyzed, as well as non-tariff barriers. Sub-section 5 studies subsidies and other measures affecting exports. Sub-section 6 deals with the foreign exchange regime.

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1-1 Foreign Trade Structure

Consideration of the commodity composition of Egyptian, Tunisian and Turkish merchandise exports and imports reveals the following aspects. In 1999, Turkish merchandise exports have amounted to US $26.6 billion and merchandise imports to US $40.7 billion. Exports to EU-15 formed 54 percent of total exports and imports from the EU 52.6 percent of total imports. The three export commodities with the highest shares in total exports were ‘clothing’ with a share of 24.5 percent, ‘food’ with a share of 15.4 percent and ‘textiles’ with a share of 13.1 percent. The three import commodities with the highest shares in total imports were ‘fuels’ with a share 13.2 percent, ‘office machines and telecommunications equipment’ with a share of 10.6 percent and ‘other non-electrical machinery’ with a share of 10.2 percent. In 1998, Egyptian merchandise exports have amounted to US $3.2 billion and merchandise imports to US $16.5 billion. Exports to EU-15 represented 41.5 percent of total exports and imports from the EU 38.2 percent of total imports. The three export commodities with the highest shares in total exports were ‘fuels’ with a share of 29.5 percent, ‘textiles’ with a share of 13.8 percent and ‘food’ with a share of 12.2 percent. The three import commodities with the highest shares in total imports were ‘food’ with a share of 12.2 percent, ‘other non-electrical machinery’ with a share of 12.8 percent and ‘other semi-manufactures’ with a share of 8.3 percent. Finally, Tunisian exports diversification has been slow. The share of the five main products in the total exports is still high, it passed from 79.2% to 70.7% between 1980 and 1999. Nonetheless, the relative shares of these products have changed. Textiles moved up to first place instead of Petroleum and derivatives, with a share exceeding 40%. While Tunisian imports are dominated by textile and machinery and mechanical engines, which both represent more than one third of total imports. Tunisian foreign trade is largely marked by the predominance of exchanges with EU. The exports to and imports from five of EU countries represents 74% and 64% of the total Tunisian exports and imports in 1999, respectively.

1-2 Liberalization Policies

After pursuing an inward-looking development strategy the three countries switched, at different periods, to an outward-looking orientation due mainly to the crises into which the economies had plunged. Egypt was the first to open up to the world economy in 1974; and due to the dramatic fall in growth during 1986 the country responded by embarking on a fundamental reform. However, the reforms were fragmented and did not reflect an overall strategy for structural adjustment. Thus, with the mounting economic difficulties in the early 1990s, the Government of Egypt responded in May 1991 by launching an Economic Reform and Structural Adjustment Program (ERSAP) that gained the support of the International Monetary Fund (IMF) and the World Bank (WB). On the external front, the signing of the GATT/Uruguay Round agreement in 1995 fostered Egypt’s commitment to liberalization. Egypt, further, is in the process of implementing a partnership agreement with the EU. In 1998, a free trade area agreement with Arab countries was implemented as well as a common market agreement with East and South African countries. Other regional and bilateral free trade area agreements under consideration include Turkey and the USA.

Turkey had switched over to outward oriented policies in 1980. The policy of further opening up the economy was pursued with the signing of the agreement establishing the World Trade Organization, in Marrakesh on April 15, 1994. Furthermore on March 6, 1995, it was agreed that Turkey would join the European Customs Union starting January 1, 1996. According to the Customs Union Decision (CUD) all industrial goods except the "European Coal and Steel Community" (ECSC) products circulate freely between the parties as of January 1, 1996. In the case of ECSC products, Turkey has signed a "Free Trade Agreement" (FTA) with EU in July 1996 as a result of which ECSC products received duty free treatment between the parties starting 1999. In order to establish freedom of movement of agricultural products, Turkey according to the CUD will have to adjust its policy in such a way as to adopt the Common Agricultural Policy. In order to adopt EU’s preferential trade agreements, Turkey has signed FTA’s with the «European Free Trade Association» (EFTA) countries, Israel, and «Central and Eastern European» (CEE) countries. FTA’s are being discussed with Tunisia, Egypt, Morocco and Palestine. Turkey still has to adopt the Generalized System of Preferences scheme of EU.

Tunisia opened up its economy, in 1986, following the signing of a Structural Adjustment Program with the IMF and the WB. Since then, Tunisia has shown many signs of opening up its economy: in 1989 it became a member of GATT, in 1994 a member of WTO, in 1995 it signed an Association Agreement with the EU aiming at progressive establishment of a free trade area during the period 1996-2007.
Furthermore, agreements of free trade have been signed with Jordan, Egypt, and Morocco, as well as an agreement of an Arab Free Trade Area between 1998 and 2007.

1-3 Market Access Issues for Goods

Since the tariff structure is one of the main trade policy tools, an assessment of tariff height is undertaken through simple average and weighted average summary measures. The dispersion of tariff rates is investigated through the coefficient of variation. The higher this coefficient is, the more differentiated the tariff structure will be. Another indication of dispersion is given by the tariff peaks or spikes, which refer to the ratio of lines for which the tariff rates exceed a reference level to the total number of lines. Two sets of ratios have been computed using two reference levels: the first is called «international peaks,» and the second is «national peaks». A large number of peaks implies a highly non-uniform tariff structure. Evaluation of the structure of protection is further undertaken by considering the commitments to WTO in terms of bound tariffs, and then by comparing the bounds with the applied tariff rates, in order to foresee the likely future trend of the tariff height according to the countries’ commitments to WTO. The core analysis focuses on the SITC tariff lines grouped in 15 sectors.

1-3-1 Tariff Height

While Egypt’s tariffs have clearly been trending downward, it is still believed that they are high. Calculations reveal that the average weighted applied tariff rate is 13.2 percent, which is about two thirds of the simple average (20.2 percent). According to these estimates, current Egyptian import tariffs are having the same effect as an export tax of 10% to 13%. The tariff rates in Egypt increase with the stage of production. Raw materials generally receive nominal protection in the range of 0-10 percent, consumer goods in the range of 40 percent and above and intermediate goods in between. Capital goods, specifically non-electrical machinery, have recently been subjected to a reduced rate of 5 percent. While this escalation of tariff structure aims to foster manufacturing through import-substitution, in fact it creates an anti-export bias which is inconsistent with the current liberalization and export promotion strategy. However, in assessing the burden of input tariffs on exporters, calculations showed that tariffs provide negative effective protection for exporters. Value added for firms that decide to export appeared to be on average 6.9% to 14.6% lower than it would be in the absence of tariffs on inputs, depending on how well the duty drawback scheme works. This may act as a serious impediment to competitiveness and a substantial disincentive to export particularly non-traditional exports. In addition to the tariff rates stipulated by the customs law and its amendments, imports into the country are subject to supplementary charged of 3 percent and 4 percent of the value of the consignment according to the tariff band.

On the other hand consideration of applied Turkish tariff rates reveals that average applied tariff rates applicable on imports from EU amounts to 43.4 percent in the case of food, 3.1 percent in the case of agricultural raw materials, and 0.9 percent in the case of other chemicals. In all other sectors of the economy the average applied tariff rates on imports from EU are zero percent. Similar figures hold for the weighted applied rates. The weighted average tariff rate is 21.4 percent in the case of food, 0.8 percent in the case of agricultural raw materials, and 0.1 percent in the case of other chemicals. As emphasized above, Turkey has signed FTAs with EFTA countries, Israel, and CEE countries. The applied tariff rates on imports from those countries are similar to that for EU. In the case of third countries the average applied tariff rates applicable on imports from non-EU countries with no FTA’s with Turkey amounts to 46.4 percent in the case of food, 3.6 percent in the case of agricultural raw materials, and 5.5 percent in the case of manufactures. In manufacturing the highest rates apply in the case of clothing, iron and steel and textile products. Similar figures hold for the weighted applied rates.

Consideration of bound tariff rates in Egypt shows that these rates exhibit wide-ranging variations across different sectors of the economy. The simple and the weighted average bounds for different sectors range, respectively, from 13.3 percent and 9.6 percent in the case of ‘agricultural raw materials’, to 54.4 percent and 32.2 percent in the case of ‘automotive products’ and those for the entire set are 28.8 percent and 21.8 percent respectively.

While consideration of bound tariff rates in Turkey reveals that 81.4 percent of tariff lines have been bound in the case of agricultural products, 14.9 percent in the case of mining products and 36.5 percent in the case of manufactures. The proportion of bound tariffs exhibits wide-ranging variations across different sectors of the economy. Whereas 83.3 percent of all tariff lines are bound in the case of food.
products the proportion goes down to 1.5 percent in the case of clothing products. On the other hand, the simple and weighted bound mean tariff rate is respectively 62.6 and 40.2 percent in the case of agricultural products and 20 and 9.3 percent in the case of manufactures. Whereas the simple and weighted bound mean is successively 73 and 63.6 percent in the case of food products, the mean goes down to 3.3 and 0 percent in the case of pharmaceuticals.

Comparison of Egyptian bound tariff with applied tariff rates reveal that Egypt’s commitments to WTO do not generally lead to expect further reductions of the tariff levels and dispersion, unless the government of Egypt decides unilaterally to take this step to gain efficiency and enhance competitiveness of Egyptian products. The averages of bound tariffs (both simple and import weighted) exceed the corresponding applied tariffs for all sectors considered with the exception of one sector, namely clothing.

Examination of the difference between applied rates and those that are bound reveals that the Turkish tariff rates have been bound at much higher levels than the corresponding applied 1999 MFN rates when one considers the simple averages. On the other hand when one considers the weighted averages the figures reveal that GATT bound tariff rates are lower than the applied tariff rates in the case of trade with third countries for textiles, clothing and other products. Thus there are products for which the bound rate is less than the MFN rate. In those cases Turkey will have to decrease its applied tariff rates to the levels of bindings.

With respect to Tunisia, the nominal rate of protection (NRP) as well as the effective rate of protection (ERP) were examined. It was noted that both rates witnessed a rapid decline, during 1986-1990, by 20 and 26 points respectively. On the contrary, both rates increased, during 1990-1995, by 5 and 12 points successively. It is worth noting that this was not due to a more protectionist policy, but rather to Tunisia’s adhesion to GATT in 1989, and consequently to its commitments to transform all forms of non-tariff protection into tariff equivalent. During the period between 1995-1998, the NRP of all the industrial products decreased. This is justified by the complete abolition of tariff on equipment goods coming from EU and by the progressive reduction of tariffs on a large number of finished goods. This resulted also in significant reduction in the ERP of industrial products, with the exception of plastic and chemical ones. Nonetheless, the interpretation of the protection rates evolution should only be approximate, because of the existence of a multitude factors acting in different directions and because of the tariff dismantling in different proportions according to the imports’ origin (EU, certain Arab countries, and the rest of the world).

1-3-2 Tariff Dispersion

Further investigation of the Egyptian tariff rates shows a highly dispersed tariff structure. Duties considerably differ across sectors of the economy. They range from zero to 50 percent as a norm and reach exceptionally high levels on some items (tobacco, poultry, automobiles and alcoholic beverages). An indication of this dispersion in rates is given by the coefficient of variation. It has been estimated at about 72 percent. Another indication of dispersion is given by the tariff peaks or spikes. Study of the tariff spikes reveals that more than half of the actually imported tariff lines are international spikes; while less than 1 percent of these lines are national peaks. The dispersion of Egypt’s tariffs along with their average height contribute to low productivity growth, and divert production, new investments and employment away from the most promising sectors of the economy, including non-traditional industries, such as manufactured exports.

In the Turkish bound tariff schedule 27.4 percent of the tariff lines are international spikes. The proportion of national spikes is 13.6 percent. The schedule shows a highly differentiated distribution of tariffs. Not surprisingly, the largest number of peaks is to be found in agriculture. The international peaks make up 78.8 percent of the lines in food sector, and the proportion goes down to 1.5 percent in the case of clothing products. Similarly the national peaks make up 63.5 percent of the lines in food sector, and the proportion goes down to 0 percent in the cases of mining, iron and steel, inorganic chemicals, pharmaceuticals, other chemicals, power generating machinery, other non-electrical machinery, and electrical machinery and apparatus. Furthermore, we note that maximum bound tariff rates are in food, organic chemicals and other chemicals sectors.
1-3-3 Non-Tariff Barriers

In Egypt the major non-tariff barriers (NTBs) include prior import deposits, and standard specification and quality control. According to the system of prior import deposits, importers in Egypt were required to deposit an amount equivalent to the value of imports. This obviously acted as a tariff surcharge and added to the protectionist bias of the trade regime. In 1991, such deposits were reduced and interest was paid on them. As of March 1999; and in order to relieve pressure on foreign exchange holdings; this NTB was reinforced only on imports of consumer products and manufactured durables. Regarding quality control it is increasingly gaining importance as an NTB to trade, since 1994. In practice, the use of quality control has become a means to protect local industry through limiting imports by adding bureaucratic ties to the process. Egyptian standards on imports are considered a trade barrier by the EU. The current quality control system has two main deficiencies: the multiplicity of agencies involved in issuing and enforcing the regulations and the lack of transparency and due process in the system. Moreover, technical specifications and regulations, act as non-tariff barriers and increase the effective rate of protection.

Besides the above mentioned NTBs Egypt has implemented anti-dumping, countervailing and safeguards measures, as well as rules of origin. The recent cases adjudicated have all complied with WTO norms. Some preliminary estimates of the economy-wide impact of the current quality system suggest that the cost impacts are highest for food-related and consumer goods’ producers and traders and smallest for industrial products and pharmaceuticals.

Consideration of non-tariff barriers (NTB) applied by Turkey reveal the following aspects. The importation of some commodities such as narcotics, ozone depleting substances, coloring matters, measurement instruments not conforming to Turkish standards, arms and ammunitions, and gambling instruments are prohibited by law for a variety of reasons such as health, environment, security, public morals and fulfillment of international obligations. On the other hand importation of certain items such as telecommunications related items, some machinery, some motor vehicles, transmission apparatus, some chemicals and a number of items related to civil aircraft require prior import licenses. Furthermore the importation of old, used, renovated, faulty and obsolete goods is subject to permission by the Undersecretariat of Foreign Trade. In the case of textile and clothing products we note that the CUD included specific provisions with respect to their trade. Besides the import quotas on certain textile and clothing products, Turkey has also introduced quotas for imports of some products originating from China. Regarding the safeguard actions, the Undersecretariat of Foreign Trade has the authority to propose, apply and monitor surveillance and safeguard measures, as well as to determine the quantities and/or values of quotas, in order to protect domestic industries. But Turkey has not initiated until the year 2000 any investigation nor applied any measure against WTO Members within the framework of the GATT Article XIX. Finally note that Turkey has been an active user of its anti-dumping legislation. The measures mainly affected textile products, base metals and articles thereof. Finally, with respect to technical barriers, the Turkish Standards Institute (TSE) sets the standards for products. Recognition of testing procedures has been assured by mutual agreements concluded between Turkey and EU member States. Furthermore a National Quality and Accreditation Control body was established in 1995 under the chairmanship of TSE. Recently the law establishing an independent accreditation council working in accordance with EU practices has been enacted. The aim is to ensure the recognition of Turkish laboratories, testing and certification bodies by the EU.

Since 1995, Tunisia transformed the non-tariff protection measures into tariff equivalent due to its commitments towards WTO. However, some laws and decrees established safeguard actions to protect the national products. These actions may take the form of quantitative restrictions or increases in tariff rates. The period during which these measures can be applied must not exceed 4 years. The Tunisian legislation allows the use of anti-dumping and countervailing measures to protect national products against unfair practices of importation. Finally, Tunisia applies national and international regulatory norms in terms of quality.

1-4 Market Access Issues for Services

Liberalization of trade in services has not been in the agenda of developing countries until the beginning of Uruguay Round of multilateral trade negotiations. An examination of sectoral GATS commitments of Egypt reveals that the country has committed itself to trade reforms in four out of the twelve service sectors: construction and related engineering services, financial services, tourism and transport services.
Although the number of sectors where Egypt has made commitments cannot be a means of a comprehensive evaluation of the extent of a country’s liberalization of services, it could serve as a preliminary indicator of how Egypt is similar to, or different from, groups of WTO countries. With regard to the Egyptian banking sector, an international rating agency identified it, in particular the public sector banks, as a key area for reform. The increasing attention that this sector has received from the Egyptian authorities, as well as from the World Bank and the IMF, over the past few years, resulted in a significant improvement of the public sector banks and the supervision regime. In the insurance sector, non-Egyptians may now manage insurance companies based in Egypt, whereas under former laws, all insurance companies operating in Egypt had to have an Egyptian managing director. However, it is emphasised that legislative reforms are essential before privatisation can occur. In addition, a modernisation program for insurance procedures would be required before government could pursue more than preliminary privatisation plans. As to transport services, despite favourable location, costs of doing business through Egyptian ports are 15-20 percent higher in terms of freight and handling charges, than those of Cyprus, Greece, Israel and Turkey. Important measures have been undertaken, and major projects are under development. This, in addition to liberalising the Egyptian maritime transport sector in the context of GATS commitments, would lower the costs of exporting and importing and would greatly enhance competitiveness.

On the other hand, besides the commitments under GATS, Turkey is to liberalise its trade in services with EU. Consideration of the horizontal General Agreement on Trade in Services (GATS) commitments of Turkey reveals that Turkey has placed no restrictions on cross-border supply and consumption abroad. Regarding commercial presence the commitments require that the minimum amount of foreign direct investment be $50,000. The investment is to be authorised by the General Directorate of Foreign Capital of the Undersecretariat of Treasury as long as it does not exceed $150,000 and by the Council of Ministers for investments above $150,000. Foreign firms are permitted to acquire real estate in Turkey pursuant to Foreign Investment legislation provided that the real estate to be acquired is related to the investor’s permitted activities. But foreign controlled enterprises are prohibited from engaging in real estate trading. Turkey restricted the movement of natural persons except for the entry and temporary stay of administrative and technical personnel and service sellers. Furthermore, Turkey declared that professions like doctors, dentists, pharmacists, nurses, opticians, lawyers who practice in Turkish courts and accountants be assigned to Turkish citizens. Finally, sectors such as postal services and telecommunications, railways, lotteries in cash and public utilities are closed to private investments because of public monopolies.

A close examination of the sectoral GATS commitments of Turkey reveals that Turkey has made commitments in 9 sectors out of the twelve services sectors considered under GATS. These sectors include: business services, communication services, construction and related engineering services, distribution services, educational services, environmental services, financial services, health related and social services, tourism and travel services. However, these commitments do not cover all sub-sectors within these nine sectors. Finally, a closer examination of liberalization of financial services shows that Turkey has placed no limitations on national treatment in the banking and the insurance sectors, but has kept restrictions on market access.

1-5 Measures Affecting Exports

All explicit and implicit taxes on exports from Egypt have been removed, by the early nineties. All non-tariff barriers (such as export bans, export quotas, prior approvals and quality control) on exports have also been removed or considerably alleviated. Quality control requirements are only maintained for foodstuffs. On the other hand, export incentives in Egypt include the duty drawback and temporary admissions systems. Discrimination between public and private sectors in foreign trade activities has been removed.

With respect to Turkey, it joined, in 1985, the GATT Subsidies Code, agreeing to eliminate export subsidies by 1989. Recently Turkey has eliminated most of the export incentives. Within this context, GATT legal subsidies such as research and development subsidies and subsidies to facilitate the adaptation of plants to new environmental regulations have been introduced in 1995. Cash subsidies are extended to a number of agricultural products and processed agricultural goods. Other subsidies consist of duty concessions, export credits and export insurance, subsidies to R&D activities, subsidies to projects related to technical barriers, subsidies to trade fairs, market research, educational activities, trade marks,
intellectual property rights, and employment subsidies. Under duty concessions exporters are exempt from a number of duty concessions such as the stamp tax, and exporters can import duty free under the inward-processing regime scheme.

However, the exportation of certain commodities is subject to registration and of some other commodities are prohibited for various reasons including environment, health or religious reasons. All other commodities can be exported freely.

In Tunisia a «Program of Export Development» has been formulated to enhance the firms’ access to international markets through technical and financial assistance (subsidies of 70% of the costs). A technical control of conformity to norms is applied to guarantee a higher competitiveness of national products.

1-6 Foreign Exchange Regime

In 1991, Egypt took steps towards shifting from multiple exchange rates to a uniform rate and a real devaluation. Since then, the nominal exchange rate of the Egyptian pound vis-à-vis the US dollar, being used as a nominal anchor, has been roughly constant. This has resulted in a continuous real appreciation reaching about 40% in 1998. About 9% of this appreciation is due to differentials in inflation rates between Egypt and its trading partner countries. The rest is accounted for by the rise in the value of the dollar relative to other countries’ currencies, while the Egyptian pound has remained constant against the dollar in nominal terms. This appreciation penalizes exports, partly offsetting the opportunities created by alleviating the burden of regulations and eliminating controls, particularly in the agricultural sector.

In Turkey foreign exchange operations and international capital movements were liberalized entirely in 1989. In line with the full convertibility of the Turkish lira, banks were left completely free in determining exchange rates in their operations in 1990. In this market the Central Bank has been intervening through open market operations to smooth out large fluctuations in real exchange rates.

Since 1978, Tunisia has been pegging its currency (dinar) to a basket of currencies. During the 1980s this basket was enlarged twice, first in the beginning of 1980’s to include currencies of Tunisia’s new trading partners, and in 1985 to add currencies of Tunisia’ main competitors. This necessitated the change of the used weights and reference period. Furthermore, a devaluation of the Tunisian dinar by 10% was undertaken, in the context of the Structural Adjustment Program, followed by a series of readjustments to devalue the dinar in order to adjust the real exchange rate and, consequently, enhance the Tunisian exports’ competitiveness. However, while both spot and forward exchange rates were fixed by the Central Bank until 1994, a spot exchange market was created in 1994, and in 1997 a forward office was established in this market.

To assess the impact of foreign exchange rate policies on foreign trade, an estimation of export and import demand logarithmic equations was attempted using OLS method. Whether a nominal or a real depreciation can help net exports is controversial. In trying to resolve the prolonged dispute about the likely effect and the effectiveness of a devaluation on exports, Egyptian and Tunisian export demand equations were estimated, with the real effective exchange and the foreign demand (represented by the export-weighted real gross domestic product index of each country’s trading partners) as explanatory variables. In both cases, results have emphasized the weak role of exchange rate variations on Egyptian and Tunisian exports’ performance, indicating that export promotion is not entirely an exchange rate problem in these countries, but rather a behavioural and institutional one. Consequently, a continued policy and institutional reform effort is crucial to resolve the weak export performance and improve the countries’ economic responsiveness to normal economic price signals like the exchange rate.

Conclusion

Reform and liberalization of the trade regime appeared to be one of the major components of ERSAPs adopted by Egypt, Tunisia and Turkey. The first element in the reform process was the reduction of the level and variance of import tariffs and further import liberalization through removing the remaining quantitative restrictions and other forms of non-tariff barriers. The second element was the promotion of exports through improving duty drawbacks, provision of export credits and of other subsidies. The third element of the trade reform was the devaluation of national currencies and the commitment to a flexible exchange rate policy.
The three countries’ commitment to liberalization was fostered by the signing of the GATT/Uruguay Round agreement in 1995, and further by signing several regional free trade area agreements.

In spite of serious attempts at phasing out NTBs on imports, and at reducing some others, their production coverage remained high in several activities in some of the countries under consideration. NTBs on exports have also been phased out. However, it is worth studying the impact of remaining NTBs, transactions costs and bureaucratie ties on the costs of imports and exports, in a comparative context, as it is believed that they burden exports with additional costs and hence tend to reduce competitiveness.

The study further emphasized the evidence on the weak role of exchange rate variations on Egyptian and Tunisian export performance. All the results indicate that the exchange rate in both Egypt and Tunisia did nor exhibit the usual impact on exports predicted by economic theory during the period under consideration. These results may warrant a more disaggregated and focussed study of the impact of changes in the exchange rate on the relevant trade magnitudes, particularly on exports.

II. LABOUR MARKET COMPETITIVENESS AND FLEXIBILITY

Introduction

Competitiveness, depends, among other things, on labour productivity and on labour cost. Within a given country, although average cost and average productivity matter, labour may be relatively more competitive in some sectors or in some firms than in others. Competitiveness does not imply that the lower the cost of labour the better for a country. The objective should be to increase real income, including real wage, while keeping wages at sustainable levels, that is while remaining competitive. So, the main question that arises is: how to measure labour cost and competitiveness and to assert that a country's labour is or not competitive? Countries like Egypt, Morocco, Tunisia and Turkey face difficult choices, and may have to restrain wages and other labour costs, at least in the short run, in order to be competitive, because their productivity is not high enough.

The purpose of the labour studies is to analyze the labour market in the respective countries and the impact of labour on competitiveness, that is on productivity and on labour cost. The flexibility issue is emphasized, since it is often claimed that labour market rigidities, associated with labour regulations, increase the cost of employment and thus hinder labour competitiveness and aggravate unemployment. However, the evidence does not fully confirm the rigidity in these markets, given the low degree of enforcement of the existing regulations and the importance of the informal sector.

After considering in sub-section 1 the main characteristics of the labour market in the four countries; sub-section 2 studies labour market flexibility and sub-section 3 the characteristics of formal and informal sectors. Productivity, real wages and unit labour costs, mainly in manufacturing, are analyzed in sub-section 4.

For the analysis of the mechanisms of the labour market, wage formation and labour unit costs in different segments of the labour market and the links between these segments, the approach developed by Agénor (1996) is followed.

2-1 Labour Market Structure

The structure of the labour force, that is of the labour supply, is first analyzed, then labour demand and unemployment are considered.

2-1-1 The structure of the labour force

The following criteria are considered: age, urbanization, skill level, gender and professional status.

Although overall population growth is slowing down, urban population and the labour force are still growing at a very high rate (Table (2-1)), particularly the young urban labour force. The proportion of people between the ages of 15 and 60, represents the highest and most rapidly increasing proportion of the populations (Table(2-2)). Moreover, rural to urban migration is quite strong while international immigration, to Europe and to the Gulf countries, was brought to an abrupt halt during the nineties.
Table (2-1)
Total and Urban Population: Size and Growth

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<td>Size (million)</td>
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<td>Egypt</td>
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<td>Morocco</td>
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<td>Tunisia</td>
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<td>Turkey</td>
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Source: Country Studies and World Development Indicators, The World Bank 1998

Table (2-2)
Population Structure by Age Group

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<td>64</td>
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<td>64 or more</td>
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<td>Total</td>
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</table>

Source: Country Studies and World Development Indicators, The World Bank 1998

Women, in the four countries, are participating at a high rate in the labour force. The rate of annual growth of the female labour force is much higher than for males. Hence the share of women is increasing. For men, the rate of participation in the labour force is even decreasing mainly as a result of longer education.

Thus, the proportion of young people and of women in the labour force, is increasing.

The labour force is also becoming more and more educated. In all countries, the illiteracy rate has gone down and the percentage of those who attended high schools or universities has gone up very significantly: approximately 30 percent have a secondary education in Egypt and in Tunisia, for example in 1996, compared to around 13 percent in 1976.

However, this progress should not hide the fact that the majority of the working people is still lacking basic skills and have had little education. More than 50 percent never attended a secondary school or any vocational training, or had any well defined skills in Morocco, Egypt, Tunisia and Turkey. This is particularly important for people looking for a formal wage earning job.

The proportion of wage earners is, indeed, an important parameter as regards the way the labour market operates. In all of the four countries, although the overall proportion of wage earners is important and increasing, other forms of employment prevail too. Independent workers are in large numbers, and family non-paid labour is a significant part, especially in the rural sector (in agriculture). In agriculture, the share of wage labour has even been going down, while the share of family labour has surprisingly been rising over the last two decades.

Overall, wage earners constitute a strong majority (nearing 70 percent), but their proportion is still lower than in a typical developed economy. This parameter is quite fundamental, given that open unemployment is basically linked to the category of wage labour, and more clearly so to the formal urban sector. Elsewhere, underemployment is more relevant than unemployment.

2-1-2 The labour demand by sector

Which sectors are creating more jobs, and what is the structure of labour demand in the four countries?

As expected, people are leaving the rural areas and agriculture (which includes forestry and fishing) looking mainly for urban activities, nevertheless agriculture provides a third or more of the employment
in Egypt, Morocco and Turkey with lower productivity, implying that the potential for rural to urban migration is high, particularly for these three countries. In general, manufacturing is growing but not fast enough to absorb all the potential supply of labour; services, which are currently growing the fastest do not respond rapidly enough either.

Table (2-3) indicates that services employ the majority of the labour force. They also employ most of the educated. The educated are hired by the government: central and local government and state-owned enterprises, including banking and financial firms, which are still largely state-owned. Therefore, outside these services, not only for agriculture but also for manufacturing, the bulk of the employees have little school education (often illiterate or with a primary education only), which confirms that the high rate of unemployment among the educated young people is not only due to a mismatch between their training and the skills demanded but also to the lack of demand for skilled workers. All of this suggests that industries in the four countries remain in their majority low skill industries, and as long as the demand for skills is low, the rate of unemployment of the educated will be persistent.

<table>
<thead>
<tr>
<th>Table (2-3) Labour Force by Economic Activity (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sector</strong></td>
</tr>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td>Manuf. Industries</td>
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<tr>
<td>Other industries</td>
</tr>
<tr>
<td>Construction</td>
</tr>
<tr>
<td>Services</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Source: Country Studies and Laborsta, ILO

Of course, this must be a major concern. On the one hand, the countries lack skills and need more human capital in order to grow, and, on the other hand, a substantial and even increasing part of their educated are unemployed, which means that:

- the education system is not producing human capital appropriate for the labour market,
- and/or that investment in physical capital is not high enough, and skill intensive enough, to absorb all the educated.
- It may also suggest that the labour market works inefficiently.

2-2 Labour Market Flexibility and Institutions

Flexibility in the labour market refers to the ease with which employment and wages adjust, usually downward when there is unemployment. To what extent is unemployment due to market rigidities and regulations?

The main features of these regulations are: minimum wages and labour cost, and restrictive hiring and firing rules.

2-2-1 Minimum wages and labour cost

Labour cost is defined by the International Labour Office (ILO) as "the cost incurred by the employer in the employment of labour" including social security contributions, severance payments, notification indemnity, employer's contribution for housing and social funds, vocational training expenses, funds related with sports center and canteen facility... In total, the share of fringe costs may be very important; it reaches 60.5 percent in Turkey for the formal sector. In this country, social security is a particularly heavy burden for the labour market and for the economy as a whole. Moreover, minimum wages are imposed and the establishment of trade unions and syndicates on a democratic basis is a right guaranteed by law and even by the constitution in the four countries.

The above considerations reveal that factors such as the characteristics of social security systems, social safety nets, system of taxation and labour market regulations are important in determining conditions in the labour market, and hence labour market flexibility.
These requirements are, indeed, quite constraining if they were really complied with. But, actually, compliance within the private sector is not always enforced, especially in smaller firms where labour unions are not strong enough. Lax enforcement of the law, which is often the case, as emphasized by Agénor (1996), provides incentives to evade the law.

As to minimum wages, they are usually determined periodically by a committee comprising representatives from trade unions, employers and the government. Minimum wage varies across countries and over time and depends on the real power held by unions. In fact, workers’ syndicates in all these countries have played a variable role in setting the wage levels. Their role is often limited by the lack of sufficient independence. This is, to some extent, less so recently in Turkey.

Union membership is still limited in most of these countries. In Egypt, it is for all workers about 25 percent of the labour force and only 25 percent of the members are private-sector workers, despite the large base of employment in the private activities in tourism, agriculture and transport. Representation in other countries with similar economic conditions, such as Morocco and Tunisia hardly exceeds 10 percent of the total labour force.

Real wages have been indeed quite flexible and minimum wages are seldom effectively restrictive and when they are high, they are not always enforced. Inflation is such that real wages fluctuate and are indirectly sensitive to the level of unemployment and to the macro economic situation.

2-2-2 Regulations in the labour market: restrictive hiring and firing rules:

Labour regulations can change the price of labour, its quantity, its quality and the way labour is exchanged in the market. We consider in this section the regulations on hiring, firing and working hours.

**Recruitment:** for the four countries, the typical employment contract is supposed to establish a permanent and full-time relationship between the employer and the employee. Although hiring procedures in the public sector differ widely from those in the private sector, the above rule is a rule of law which is to prevail everywhere. In practice, work contracts are usually of unlimited duration only in the unionized private sector and in the public sector.

In addition to the indefinite labour contract, the labour laws allow, under specific conditions for each of the four countries, for temporary or fixed term contracts. This distinction normally depends on the nature of the work itself, rather than on any subjective will or decision of the parties; but, in fact, this depends really on the balance of power between employers and employees and on the sector they belong to. Anyhow, things are changing. In Tunisia, employers can already legally choose among the following employment contracts when hiring a new employee: full-time permanent employment contract, which is the normal form of employment contract; contract for temporary jobs which do not entail any severance payments in case of dismissals; fixed term contracts; part-time contracts; and training and apprenticeship contracts for youngsters to acquire a certain skill or trade.

The main feature of temporary and fixed term employment contracts is that they involve substantially lower firing costs than the typical permanent employment contract. Furthermore, workers employed under fixed term or temporary contracts cannot sue the employer for "unfair" dismissal. Obviously, employers tend to prefer this contract category, and they try to avoid permanent employment.

**Working Hours:** The maximum number of normal working hours is set by law. The maximum number of overtime hours is restricted. Workers are also entitled to a minimum vacation period (at least 12 and at most 34 days per year in Turkey for example). The holiday period can be extended by collective bargaining. The labour laws also determine daily working hours. Overall, there is little flexibility in the organization of working time, according to labour laws, which, again, are only partly enforced.

**Dismissals:** Dismissal of workers is regulated. There is in all cases a minimum period of notice for dismissals. In addition, labour laws require that workers dismissed at the employer's initiative (except disciplinary dismissals) receive severance payments. Dismissed workers may sue their employer in the labour courts. If the court decides in favour of the worker, that is if the dismissal is judged as "unfair" the minimum severance payment is increased. This procedure aims at protecting workers rights but it obviously raises the cost of labour and does not facilitate employment. Everywhere, there is an ongoing debate as regards the need to lower such costs by introducing simpler and less exacting regulations.
Reforms are drafted and being discussed in Egypt and Morocco. Only in Tunisia reforms have already been introduced and two new laws in favour of more flexibility were passed, allowing mainly for:

- more freedom as to the duration and the type of contracts; and more room is given to fixed term contracts,
- simplified procedures in case of layoffs, and
- putting a limit on maximum compensation in case of firing.

The new law states that contracts may be either permanent or for fixed term. Employers could offer fixed term contracts, in case when the firm is facing unusual demand, or when it needs to substitute for absent workers. Nevertheless, consent of both the employer and the employee is also a valid justification for a fixed contract, but not for longer than four years. After four years, the contract automatically becomes a permanent contract. This rule carries the incentive to eventually layoff workers before the four year term.

These amendments are more than four years old and not much seems to happen, as a result, in the Tunisian labour market in terms of employment and labour attractiveness. In general, it is right to ask whether the flexibility issue is so determinant.

Tentative estimates of the impact of hiring and dismissal costs on labour cost and employment indicate that the effects due to rigidities are not so high.

However, it is also quite clear that strict and costly regulations tend to be more difficult to enforce. In Turkey, where the regulations are very protective, more than 60 percent of the employed labour is in the informal sector. This rate is high in the four countries.

2-3 The Formal and Informal Sector

The labour market can be broken down into two major segments. First, the formal sector, which is subject to most government regulations; it includes: government administration units, public enterprises and the formal private sector. The second segment is the informal sector, subject to only limited government and work regulations. This includes most of the agricultural sector and the informal private sector. The type and strength of the institutions and their ability to enforce compliance with the regulations is also fundamental; excessively restrictive laws and lax enforcement lead to a larger informal sector.

There is a large informal labour market which is free from most type of labour regulation and which does not pay most of the taxes and related charges mentioned above, but there are various estimates regarding the size of this market in each of the four countries because it is hard to agree on a single operational definition of the informal sector and because of the lack of data. However, various estimates, for the four countries, indicate that the size of the informal sector is between 30 and 60 percent. There is also some indication that it has been increasing over the last two decades.

Segmentation does not imply that each segment is closed and that there are no movements between the two sectors. The links exist and have implications on wages and employment. Indeed, wage variations in the formal or in the informal sector have impacts on employment in both sectors, and more employment in one sector could mean less employment in the other, but not always, as the degree of mobility between the formal and the informal sectors depends on the level of skill. The survey undertaken in Morocco confirms that skilled workers are very seldom attracted by the informal sector, except as employers.

When employment decreases in the formal sector, it may increase in the informal sector. In particular, less public sector recruitment or public sector layoffs, as a result of stabilization and structural adjustment, may lead to more informal activities; and so do excessive wage increases in the formal sector.

**Growth and future employment are hindered by the outgrowth of the informal sector.** In the informal sector, labour market is more flexible and labour cost is lower, but this does not make it necessarily more competitive and more profitable for the country. The informal sector produces mainly non tradable goods and services and does not contribute to the production of capital equipment (except buildings) and of human capital and to the production of public infrastructure. Not to mention the state of poverty, the difficult working conditions, and children employment, which are pervasive phenomena in the informal sector.
2-4 Labour Unit Cost

To be more competitive, a country should try to hold down its unit labour cost and may do so either through wage restraint or, preferably, through productivity enhancement. Labour productivity depends on a number of factors including capital accumulation, education and training, technological change and infrastructure.

<table>
<thead>
<tr>
<th></th>
<th>Egypt</th>
<th>Morocco</th>
<th>Tunisia</th>
<th>Turkey</th>
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</thead>
<tbody>
<tr>
<td>1985</td>
<td>55.2</td>
<td>25.1</td>
<td>52.6</td>
<td>21.1</td>
</tr>
<tr>
<td>1989</td>
<td>35.2</td>
<td>36.1</td>
<td>45.5</td>
<td>18.9</td>
</tr>
<tr>
<td>1993</td>
<td>28.9</td>
<td>37.4</td>
<td>42.2</td>
<td></td>
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</tbody>
</table>

**Source:** Respective Country Papers, for Egypt, Morocco, Tunisia and Turkey.

Labour unit cost calculations allow for comparing labour competitiveness between countries and between activities within the same country.

Table (2-4) indicates that labour unit cost has declined in Tunisia, and even faster in Egypt from the beginning of the eighties to 1995, but this trend can be reversed, as it happened in Egypt afterwards.

Textiles production activities in Egypt are ranking last from the labour productivity perspective. The unit labour cost indicator confirms the same result. Chemical products had the lowest unit labour cost in 1990-1995, while textiles products had the highest one.

An important conclusion for Egypt can also be drawn, namely that the structure of the manufacturing sector has witnessed a major shift away from the traditional activities, such as textiles, and towards higher value added activities, such as chemical products, iron products and equipment. The shift entails wider use of capital-intensive techniques and hence creates relatively less job opportunities.

Indeed, comparison between countries should take into account differences in the structure of economic activities and of capital/labour intensity. International comparison is more meaningful the closer the data are to the firm or factory level.

The experience of Turkey shows how important it is to increase labour productivity in order to be competitive; Turkey succeeded in raising productivity in the manufacturing sector at an annual rate of 3.4 percent in 1995. Hence, Turkey’s competitiveness increased over the period 1980-1996 against Korea, Taiwan and Spain.

**Conclusion**

Formal labour institutions and regulations are nominally rigid and costly in the four countries, but they are only partly enforced. The informal sector represents a large part of the economy, and hardly abides by the rules. Overall, labour markets are rather flexible and real wages did go up and down as a result of macroeconomic constraints. Nevertheless, these countries would gain in instituting a more coherent framework, allowing for an adequate degree of flexibility, enhancing competitiveness, and complying with the rule of law.

Most importantly, these countries will gain, with less social conflicts, in terms of labour unit cost by increasing productivity. This is the real development challenge, but there is much to be done given the current levels of education and of capital accumulation characterizing these countries. Further investigation of relative productivity and unit labour cost at the sector activity and at a more disaggregated level needs to be implemented; but it is already possible to assert that there are sectors of economic activities in all of these countries where productivity is continuously growing and labour unit cost decreasing. Therefore, relatively speaking, each country is competitive in some activities; another way to restate and to verify the old comparative advantage principle.
III INVESTMENT INCENTIVES, MARGINAL EFFECTIVE TAX RATES AND THE COST OF CAPITAL

Introduction

Although capital income taxation is only one of several determinants of investment decisions, economists and policy makers agree that the tax system has an impact on the incentive to save and to invest. Taxation of profits often has an important impact on marginal investment. Heavy taxation raises the cost of capital, reduces profitability, discourages investment and erodes competitiveness. The purpose of the study is to assess the actual tax burden in selected MENA countries (Egypt, Morocco, Tunisia and Turkey) on new investments in real assets, and to assess whether the prevailing tax systems have discretionary effects on private investment.

To this end, the study first attempts to measure the real tax burden on capital investment by using the marginal effective tax rate (METR) as a quantitative indicator. It also examines whether tax incentives practices are taken into account. In order to evaluate the impact of the tax system on the cost of capital and hence on competitiveness, the study tries to address the following questions:

- How is the tax burden measured?
- How does the tax burden vary across countries?
- How does the tax burden vary by type of activity, type of firm and source of finance?
- What tax incentives are provided? To which activities and locations?
- How effective are these incentives in alleviating the tax burden on exports?

The rest of this section is organized as follows: sub-section 1 discusses the methodology of measuring the tax burden on capital by using the marginal effective tax rate (METR) as a quantitative indicator. Sub-section 2 shows how the tax burden varies across countries in the MENA region. Sub-section 3 investigates how the tax burden varies by type of activity, type of firm and source of finance. Sub-section 4 reviews tax incentives and assesses their effectiveness in achieving their objectives, more particularly, promoting exports and achieving regional development. Sub-section 5 investigates tax compliance and evasion and their likely impact on METR estimates. The conclusion presents some policy recommendations.

3-1 Assessing the Tax Burden on Capital: The Marginal Effective Tax Rate

The statutory tax rates are not accurate indicators of the burden and impact of the tax system on investment decisions. They usually differ substantially from the effective tax rate borne by the investor for several reasons, of which: the method used in calculating taxable income, the frequent use of credits and other taxes on investment, and the inflation rate. Besides the statutory tax rate, countries offer various tax exemptions to encourage domestic investment and to attract foreign direct investment. In addition, administrative practices and institutional weaknesses impose transactions costs on investors. Therefore the marginal effective tax rate (METR) is used to capture the impact of different aspects of the tax system (rates, incentives and administration) on the cost of capital and hence on investment efficiency and competitiveness. METR does not only reflect the incidence of the nominal tax rate as given by the business income tax (corporate and non-corporate); it also reflects all other aspects of the tax system; namely: personal taxes, other direct taxes on assets, indirect taxes on assets, in addition to tax allowances and tax incentives.

Other non-tax parameters affecting the tax burden (METR) include: the project characteristics, mainly the asset structure and the financing structure. METR is also macroeconomic indicators, such as: the interest rate and the inflation rate.

The precise methodology used to calculate effective tax rates on marginal investments is based on an approach developed by King and Fullerton (1984). This methodology has further been applied by OECD (1991) and the World Bank. Dunn and Pellechio (1990) from the World Bank, developed the METR model for their survey work on the taxation of business income in developing countries. This is a very useful and valuable tool to calculate effective tax rates for a variety of tax policies, types of investments and tax incentives. The model is based on assuming a hypothetical project with a particular before taxes internal rate of return, it generates a cash flow for the project. Given the appropriate information on tax policy, the model applies this information to the cash flow and derives the internal rate of return for the
after tax cash flow. The marginal effective tax rate is the difference between the before (BTROR) and after tax rates of return (ATROR) expressed as a percentage of the before tax rate of return.

\[
\text{METR} = \frac{\text{BTROR} - \text{ATROR}}{\text{BTROR}} \times 100
\]

So, if the BTROR is equal to 16 percent and the ATROR equals 12 percent, the METR would amount to 25 percent. Calculation of these rates of return is based on the specification of the before tax cash flow and the after tax cash flow. The cash flows are generated by following basic accounting principles and straightforward application of respective countries tax codes.

3-2 How Does the Tax Burden Vary Across Countries

Generally, there are two approaches in designing tax policy: either to apply uniform tax provisions to all activities combined with low tax rates, or to tax various activities differently in order to achieve specific economic goals such as export promotion, employment generation, or development of remote areas. The latter is usually accompanied with generous incentives and also results in a relatively high tax rate in some sectors. Evidence shows that all countries covered by the study opted for the second alternative. The impact of this choice on the tax level will be considered now, while the effects of the incentives schemes adopted will be studied later.

The literature on optimal tax theory provides little practical guidance on the choice of the overall level of taxation. Nevertheless, attempts have been made to detect whether actual corporate tax levels are high and overburden investors. Country data reveal that taxes on individual and corporate income are an important source of public revenues. However, corporate taxation appears to be particularly high in Egypt, compared with other countries in the region, as indicated in Table (3-1). Two factors help explaining the relatively high level of corporate taxation in Egypt the level of statutory tax rates and the

| Table (3-1) Corporate Tax Revenue: Cross Country Comparison, 1995( Percent) |
|-----------------------------|------------------|------------------|
| Country                  | Corporate Tax/Total Tax Revenue | Corporate Tax/GDP | Personal Tax/GDP |
| Egypt                     | 23                | 5                | 1                |
| Morocco                   | 8                 | 2                | 3                |
| Tunisia                   | 7                 | 2                | 2                |
| Turkey                    | 10                | 1                | 4                |


composition of corporate tax revenues, 60 percent of which is attributable to the oil sector, the Suez Canal Authority and the Central Bank of Egypt. It also appears that most of the burden of direct income taxes falls on corporate entities in Egypt (5 percent of GDP compared to 1 to 2 percent in other countries of the region), while in other comparator countries, the burden is more felt by individuals (2 to 4 percent versus 1 percent for Egypt).

METR estimates in Table (3-2) reveal that the tax system in various MENA countries imposes a burden on capital different from that reflected by the statutory (nominal) tax rates on profit. Sources of divergence are mainly the special tax allowances and deductions permissible under the general law, as well as the impact of indirect taxation and surcharges.

| Table (3-2) Nominal and Marginal Effective Tax Rates in Selected MENA Countries on Corporate Firms (other than Joint Stock Companies) in Manufacturing(Percent) |
|-----------------------------|-----------------|-----------------|
| Country                 | Nominal Corporate Tax Rate | Marginal Effective Tax Rate |
| Egypt                    | 32(*)           | 54.5            |
| Morocco                  | 35              | 50.6            |
| Tunisia                  | 35              | 50.5            |
| Turkey                   | 33              | 48.5            |

(*) Note that this a preferential rate imposed on manufacturing. All other non-manufacturing activities are taxed at a rate of 40 percent.

Source: Respective Country Papers on taxation prepared for the project.
Standard deductions from the annual profits of corporate firms include mainly depreciation and interest paid on debt; value added tax (sales tax) (VAT) and import duties, partially or totally on imported equipment (except for Egypt); sale proceeds of capital assets if reinvested in similar assets; carried forward corporate losses (around five years). All countries, except Egypt, impose personal taxes on distributed dividends at the rate of less than 10 percent. A further deduction from taxable corporate income in Egypt, is 25 percent of the cost of new machinery and equipment as initial allowance. In Turkey this allowance is more generous but is targeted to specified sectors with special importance, to priority regions and to organized industrial regions.

The table further indicates that although the preferential statutory tax rate, imposed in Egypt on manufacturing activities (32 percent compared to 40 percent for non-manufacturing activities), is lower than the corporate income tax in the other MENA countries, the estimated METR is higher. The main reason for this relates to indirect taxation. Tariff rates are still relatively high in Egypt, the sales tax adds an additional burden on the cost of capital, yet, Egypt, unlike all the other selected countries, does not allow any crediting of these taxes on imported capital goods.

3-3 How does the Tax Burden Vary by Type of Activity, Type of Firm, Source of Finance and Capital Asset?

Differentiation between tax treatment according to sectors of activity, organizational forms of business, sources of finance and asset types have been considered. The main findings were:

Corporate taxation favours manufacturing in Egypt and modernization of agriculture in Tunisia. Morocco and Turkey do not seem to systematically differentiate between activities.

All countries moderately differentiate between corporate and non-corporate firms in tax treatment. However, tax deductions enjoyed by corporate firms are more generous. A highly favourable and untargeted tax allowance granted to joint stock companies listed on the stock market, in Egypt, is the deduction of the imputed cost of paid-up capital.

Deduction of interest on debt from the tax base favours new investments financed by debt in all countries. Deduction of interest on debt, incurred by the firm from the tax base, reduces the effective cost of borrowing to investors thereby increasing the profitability of new investments financed by debt in all countries.

This channel is not easily accessible to non-corporate firms, particularly if they are small or medium in size and have no access to bank financing. Thus they are more likely to be faced with a heavier tax burden.

In Egypt, non-crediting of sales tax and import tariffs on machinery, equipment and vehicles discriminates against investment in these assets and favours investment in land. This raises the cost of capital in Egypt compared to all other countries of the region.

Finally, it appeared that the fiscal parameters, in Tunisia, are in favour of labour intensive activities. This result has not been observed in other countries.

3-4 Impact of Tax Incentives

Tax incentives aim at reducing the cost of investment, thereby increasing its profitability and its competitiveness. The main incentives applied in the region and affecting the cost of capital include: preferential income and property taxation, tax holidays, reduction of tariffs on imported machinery and equipment or exemption therefrom (and/or from VAT), deduction of reinvested income from the tax base, low interest credit, energy subsidies, free land allocations, and government contribution to infrastructure cost.

3-4-1 Activities Favoured by the Tax Incentives

In Egypt, incentives are untargeted and are provided to all activities under Law 8/1997, new communities and communities outside the Old Valley. Law 8 specifies sixteen activities that qualify for the benefit of the law. They range from reclamation of desert land, to industry and mining, air transportation, tourism,…
Other activities may be added by decree. Information and technology related activities have been recently made eligible for Law 8 incentives. However, in contrast to many countries, Egypt does not grant any additional tax incentives, beyond those stipulated by Law 8, to stimulate research and development (R&D). In Egypt, expenditures on R&D are a relatively low percentage of GDP, estimated at 0.2 percent compared to the corresponding figure of 0.7 percent in Turkey. Furthermore, Law 8 provides for permanent exemption from taxes, duties or customs procedures in free zones.

In Morocco, Tunisia and Turkey incentives are more targeted. They generally favour exports and regional development.

3-4-2 Impact of Tax Incentives.

Effectiveness of tax incentives in promoting exports and in regional development has been assessed through METR calculations for these activities. Table (3-3) illustrates the main results. Corporate taxation in Egypt reduces export profitability and incentives compared to other MENA countries. Export activities of corporate firms, in Egypt, do not receive any preferential tax treatment beyond that granted to manufacturing. They, thus, face a tax burden as high as 54.5 percent under the general tax law, and 36.2 percent under Law 8/1997, contrary to other countries in the MENA region. All incentives schemes in the countries considered, except Egypt, reduce the effective tax burden below the respective nominal corporate tax rates (see also Table (3-3)). The export incentives scheme, in Tunisia appears to be the most effective in reducing the tax burden on investment in export industries.

Incentives provided in free zones in both Egypt and Morocco considerably alleviate the burden of taxation on investment. However, Egypt did not succeed in converting these zones to export oriented manufacturing zones. This implies that structural factors, other than taxation, are constraining Egyptian exports.

3-5 The Impact of Tax Compliance and Evasion

Besides tax rates and incentives, tax compliance may affect investment decisions through either increasing the tax burden or creating some distortions or both. It is well recognized that tax compliance, in general, is a function of economic incentives imbedded in the tax rate and of the effectiveness of tax administration in detecting and penalizing non-compliance. Key features of taxpayer compliance in Egypt and Tunisia have been examined.

There is no estimate of transaction costs related to tax administration. However, business environment surveys provide evidence that transaction costs due to cumbersome tax administration procedures are not negligible.

Theoretically, people evade taxes when, at the margin, the expected benefits (lower taxes paid) are higher than the expected costs (penalties). In both Egypt and Tunisia, it seems that the benefits from tax evasion exceed the costs. The statutory tax rates are high, tax administration is cumbersome, and both financial and criminal penalties do not seem to be sufficiently deterring.

Estimates of tax evasion vary widely. Some sources indicate that the estimated cost of tax evasion on the Egyptian Treasury reached almost L.E.14 billion per year, of which L.E.6 billion are evasion from income tax. Official figures report it to amount L.E. 17.6 billion in 1999/2000. Another indicator of tax evasion is
the large size of the informal sector which evades taxes altogether. It has been estimated to be around 40 percent of the total Egyptian economy. For Tunisia, tax evasion has been ascertained to be important. A rough approximation of the rate of tax evasion for both direct and indirect taxation has been attempted. Globally, the rate of direct tax evasion for all sources of income has been set at 50 percent. The rate of tax evasion for VAT on domestic products in Tunisia is also believed to be at least equal to 50 percent. However, it has been reported that it is much harder to escape import tariffs and VAT on imports. While the magnitude of tax evasion seems to be high, this is not out of line with international experience.

Finally, it is important to note that the magnitude of transactions costs and tax evasion differ from one firm to another. Tax compliance is, thus, expected to affect tax payers differently. Those who adhere to the tax regulations are in an unfair competition situation compared with those who succeeded in non-complying to the tax system.

Conclusion

Although nominal corporate taxation of manufacturing is comparable in the selected countries of the region; yet the burden of taxation on incremental investments appears to be the highest in Egypt, followed by Morocco and Tunisia, with Turkey imposing the lowest burden. In general, the total fiscal burden, measured by METR, is quite high in all countries considered. However, some MENA countries succeeded in significantly reducing this burden under various incentive schemes.

Thus, through targeted incentives, Tunisia succeeded in drastically reducing the tax burden on exports to less than 10 percent, and below that of all other countries in the region, except for free zones in Egypt.

Despite generous tax treatment in Egyptian free zones, they remained inward-oriented and did not become significant export zones. In general, the generous and untargeted tax incentives reduced government revenues without, however, achieving any specific objective, particularly promoting investment in exports.

Priority regions in development receiving preferential tax treatment, particularly tax holidays, appeared to be highly favoured in Turkey and Egypt compared to Morocco and Tunisia.

Business taxation in Turkey, seems to be the most rational among the countries considered. It imposes a moderate burden on firms in general and has succeeded through targeted incentives implemented on the basis of «investment incentive certificates» to substantially reduce this burden on investment in exports and in regional development.

Morocco, through its incentives scheme, somewhat alleviates the burden of taxation on investment in exports and in priority although less than in Tunisia and Turkey.

In practice- as indicated in the Egyptian and the Tunisian cases- the tax payer manages to evade taxes and to pay no more than half of what he has to. This brings METR down to a very moderate level. These calculations are quite tentative and are based on uncertain assumptions. In particular, it is recommended to study more accurately the incidence of VAT (or of the sales tax) and to try to obtain a reasonable estimate of its impact on firms, especially on the return to investment.

Main References

1) The various Country Studies presented under the project no.: FEM-ERF/99/B1-01 to FEMISE/ERF.

