

Fostering Higher Growth and Employment in the Kingdom of Morocco



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Acronyms and Abbreviations

ANRT	National Telecommunications Regulation Agency
BMCE	Banque Marocaine de Commerce Extérieur
CAS	Country Assistance Strategy
CEM	Country Economic Memorandum
CNSS	Caisse Nationale de la Sécurité Sociale
CPI	Consumer Price Index
CRER	Constant Real Exchange Rate rule
CRI	Centre Régional d'Investissement (Regional Center for Investment)
DEPF	Direction des Etudes et des Prévisions Financières
EMBI	Emerging Markets Bond Index
EPZ	Export Processing Zone
ERP	Effective Rate of Protection
EU	European Union
FDI	Foreign Direct Investment
FEMI	Euro-Mediterranean Facilities for Investment and Partnership
FODPE	Depollution Fund
FOMAN	The <i>Mise a Niveau</i> Fund
FORTEX	Fonds de Soutien aux Entreprises du Secteur du Textile-Habillement (The Fund for Textile Restructuring)
FTA	Free Trade Agreement
FTZ	Free Trade Zone
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GOM	Government of Morocco
GTAP	Global Trade Analysis Project
HCP	Haut Commissariat au Plan
HI	Herfindhal Index
HRV	Hausmann, Rodrik, and Velasco
HS	Harmonized System
ICA	Investment Climate Assessment Survey
ICT	Information and Communication Technology
IGR	Personal Income Tax
ILO	International Labor Organization
IMF	International Monetary Fund
INDH	National Strategy of Human Development
INIA	National Institute of Agricultural Research
INSEA	Institut National de la Statistique et des Etudes Economiques Appliquées
NAFTA	North American Free Trade Agreement
NGO	Nongovernmental organization
NTB	Non-tariff barrier
OECD	Organization for Economic Cooperation and Development
OPPPT	System of Professional Training

OLS	Ordinary least squares
OTRI	Overall Trade Restrictiveness Index
PAIGAM	Support Program to Moroccan Guarantee Institutions
PPP	Purchasing Power Parity
R&D	Research and development
ISO	International Standards Organization
KEI	Knowledge Economy Index
LAC	Latin America and the Caribbean
LFPR	Labor Force Participation Rate
MAD	Moroccan Dirham
MEDA I and II	First and Second Euro-Mediterranean Partnership Program
MENA	Middle East and North Africa
MFA	Multi Fiber Agreement
MFN	Most Favored Nation
MNAS	Moroccan National Accounts System
MW	Minimum Wage
RENOVOTEL	The Fund for Tourism Restructuring
RER	Real Exchange Rate
SME	Small and Medium Enterprise
SMI	Minimum Salary Index
TFP	Total Factor Productivity
TFZ	Tangier Free Zone
TNC	Transnational company
UN	United Nations
UNAS	United Nations Accountings System
UNICEF	United Nations Children's Fund
US\$	U.S. dollar
VAM	Value Added at Domestic Market Prices
VAT	Value-Added Tax
Wafa	Moroccan Banking and Insurance company
WB	World Bank
WDI	World Development Indicator
WTO	World Trade Organization

CURRENCY EQUIVALENTS

Unit of Currency = Moroccan Dirham (MAD)

US\$1 = 8.70 MAD

(Exchange rate effective September 2005)

GOVERNMENT FISCAL YEAR

January 1–December 31

WEIGHTS AND MEASURES

Metric System

Executive Summary

Morocco's low growth is the central challenge in the country's development agenda. In the 1960s, per capita economic growth in the Middle East and North Africa (MENA) region was among the highest in the world, averaging nearly 5 percent a year. After Saudi Arabia, Morocco's growth rate was the highest in the world. This edge was lost in the 1980s however; and by the 1990s, Morocco had become the worst-growth performer in the MENA region, averaging 2.5 percent. Recovery took place between 2000 and 2004. Following good agricultural seasons and important efforts in stabilization and structural reform, growth rates recovered to an average of about 4 percent. Nevertheless, these rates will still be insufficient to significantly reduce poverty and employment.

Higher growth is critical to reduce unemployment. Labor force growth remains above 3 percent per year, and recorded unemployment stands at 11 percent. Reduction in unemployment will require sustained annual economic growth above the 5–6 percent range. In the absence of such growth, poverty reduction will stall and sociopolitical tensions will increase. During the 1990s, reforms slowed and average annual growth declined to around 3 percent. After 2001, the pace of reform accelerated. Growth entered an expansive cycle, and unemployment declined. This is a clear improvement yet still insufficient to meet the population's expectations. If unemployment is not reduced, social crisis could result.

Morocco's growth is an enigma. There are good reasons why Morocco *should* be achieving high growth: a privileged geographic position as well as significant progress in price stability, public debt reduction, strengthening of the financial system, infrastructure improvement, educational reform, reinvigorated tourism, and privatization. The country is well regarded by international risk agencies, which recognize its political and social stability.

In light of these advantages and reforms, why does growth not accelerate? This study addresses this fundamental question. Morocco is not unique in this situation. Previous studies show that only 17 of 83 countries implementing similar liberalization processes between 1960 and 2000 experienced periods of ensuing rapid growth. These studies show that periods of rapid growth are linked to removal of actual constraints to growth rather than to the fact of reforms. Reforms are important, but rapid growth relies more fundamentally on properly identifying the binding constraints to growth. In similar vein, relying solely on ongoing reform and favorable external conditions would be a risky bet. For Morocco, additional efforts are needed.

This Country Study identifies Morocco's binding constraints to growth. It applies an innovative procedure known as "growth diagnostic." This new approach is country-specific, comprehensive in its assessment, and heterodox in the measures that it recommends. It calls for activist policies for productive diversification and enhanced competitiveness of the economy. These selective reforms differ from "traditional" policy recommendations which give equal weight to simultaneously implemented, multiple reforms.

Applying this procedure, this report provides a central diagnostic. It finds that the Moroccan economy suffers from a sluggish process of structural transformation for achieving higher growth, especially on exports that have to face unfavorable external shocks arising from competitors in the main markets for Moroccan exports. This process of so-called "productive diversification" requires Morocco to enhance its competitiveness and accelerate its

transition from low to high value-added productive activities. International experience shows for strong economic performance, what is exported, not how much, is what matters most.

Four government failures are identified as binding constraints to growth: a *rigid labor market*; a *burdensome tax regime* that penalizes firms and creates obstacles to hiring skilled workers; a fixed *exchange rate regime* that has regained price stability but worked against international competitiveness in light of rigidities in the labor market; and an *anti-export bias* featuring high trade protectionism despite recent progress in tariff reductions and several Free Trade Agreements (FTAs).

In addition to these four binding constraints, three market failures are also responsible for low growth: first, *information failures* that incentive the violation of intellectual property rights and reduce the rates of return for investing in new productive activities; second, *coordination failures* between the public and private sectors; and third, *training failures* that place Morocco among countries with the least training offered by businesses, thereby discouraging competitiveness and innovation.

The Government and entrepreneurs are fully aware that Morocco needs a new growth strategy. The centerpiece of the Government agenda is the *Emergence* program, which was announced in December 2005. In addition, an *Employment Initiative* (EI) was announced in September 2005. Both decisions share the implicit vision of a new pact for growth and employment for Morocco. Both are highly positive steps in the right direction.

Complementary to such efforts and consistent with this focused approach, the CEM proposes a set of measures that would further encourage productive diversification and enhanced competitiveness. *To create a leadership structure*: Establish a coordination council headed by the highest-level authorities, including active participation by the private sector. In regard to the *short-term policy agenda*: Keep real minimum wages constant. Design and implement a neutral tax modernization reform—mainly, reduced corporate income tax and IGR rates, and a simplified value-added tax. Move gradually toward a flexible exchange rate regime. Accelerate the reduction of tariff and nontariff barriers. *To address potential market failures*: Adopt a set of fiscal incentives to new productive activities—as transversal as possible and as sectoral as needed. Introduce a competitive, transparent, and accountable selection process for the new activities that would receive incentives. Strengthen property rights. Provide additional incentives for training by firms. To further *encourage discipline and transparency*: Extend the use of contracts program.

The CEM recommends several other policies. *To prevent potential future growth constraints*: continue with the agenda of fiscal consolidation. Bring the fiscal deficit toward 3 percent and the public debt ratio down to at least 65 percent of GDP by 2008. Reduce the port and shipment fees for crossing the Strait of Gibraltar. Complete and implement an anticorruption agenda supported by an independent commission. Apply new measures to adapt abundant available financing to small and medium enterprises (SMEs), including the softening of collateral and guarantees. Develop a contractual framework including the government, universities, and vocational centers in order to increase graduation rates. *To improve the business climate*: create a unique identifier for each enterprise. Develop a credit information system. Strengthen enforcement of court contract decisions. Enact measures to enhance firms' access to real estate. *To promote employment and working conditions*: complement the CEM proposal for wage moderation by providing incentives for hiring first-time jobseekers and female workers through the temporarily reduction of the minimum wage. Work toward an eventual unemployment insurance scheme. Reform the social secu-

rity system with a view toward reducing the high gross-income replacement rate while strengthening the mandatory payment scheme.

There is no silver bullet for Morocco. However, to address growth and employment constraints, a comprehensive approach must be undertaken; and it must be implemented in sequence with a longer-term growth strategy. This will require strong initial signals to the private sector while addressing past failures of government. Parallel institutional reform will bear complementary fruit in the medium term. The World Bank recognizes the complexity of turning this vision into reality; and it will continue to support Moroccan officials in designing and implementing this top priority for the country's development.

Motivation

What makes some countries rich and others poor? Economists have asked this question since the days of Adam Smith. Yet, after more than two hundred years, the mystery of economic growth has not been solved.

—Elhanan Helpman

This Country Economic Memorandum (CEM) is a contribution to the debate among key decision makers in Morocco on the outlook for growth and employment. Key elements of such a debate are a clear understanding of the main constraints to growth, the potential policy adjustments that are needed to remove them, and the degree of activism these policies require from the Government in order to change course. In response, through separate but integrated sections, this report addresses five main questions.

- What can be learned from past growth performance, and what remains unexplained?
- What are the main binding—actual and potential—constraints to growth?
- How can Morocco improve its business environment while addressing productive diversification?
- What are the key elements of a trade strategy that would eliminate the anti-export bias and contribute to exports diversification, enhanced competitiveness, and growth?
- What key elements of an employment strategy would complement a growth strategy?

Low-growth concerns are chronic for Morocco. In part, this is inherited. In the 1960s, the Middle East and North Africa (MENA) regional economic growth per capita was the highest in the world, averaging nearly 5 percent a year. Morocco had the second highest rates in the world, after Saudi Arabia. This edge was lost in the 1980s; and in the 1990s, Morocco became the worst-growth performer in the MENA region, averaging 2.5 percent.

Macroeconomic instability combined with policy-induced microeconomic weakness was the main binding constraint that affected growth in the 1980s. This resulted from Morocco's development strategy inherited from the 1970s. The so-called "Moroccanization drive" of the economy primarily consisted of import-substitution industrialization;

agricultural self-sufficiency; restriction of foreign ownership; promotion of national control over natural resources, and public sector involvement in large capital-intensive industries, which were highly protected from competitive pressures. Financing for this inward-oriented strategy came primarily from two sources—tax revenues from export earnings associated with phosphates and agricultural crops, and external borrowing. However, international recession led to a severe deterioration of the terms of trade and a huge decline in exports earnings at the end of the 1970s. Morocco was hit with high external and internal imbalances. In 1981, the external current account reached a deficit of 12.2 percent of GDP, and the overall fiscal deficit was 14.2 percent of GDP. The external debt kept increasing until it reached an alarming three digits in 1984.

Stabilization policies and a first generation of structural reforms helped Morocco to recover high growth rates during the second half of the 1980s; however, these efforts stalled in the 1990s. According to Nsouli and others (1995), growth during this period corresponded to two broad phases of adjustment policy. During the first phase, 1981 to 1985, the emphasis was on fiscal adjustment through large cuts in capital expenditure, wage restraint, limits on hiring, tight monetary policy, and credit controls. Growth rates averaged a modest 3.4 percent, and the pace of budgetary adjustment was slower than expected. Severe droughts hurt the economy, and riots delayed tax and subsidy reforms and increased defense outlays. During the second phase, beginning in 1986, adjustment measures maintained their emphasis on stabilization. They were accompanied by structural reforms aimed at improving savings, encouraging productive investment, and shifting resources toward the export sector. This entailed a move away from direct controls and state intervention toward greater reliance on market forces. The Government also pursued an active exchange rate policy. Following an initial depreciation in real terms by 30 percent during 1981–86, the dirham maintained stability until the end of the decade. Growth in consumer prices was less than 3 percent during 1987–89. Export growth rates recovered gradually, increasing from a low average 1.8 percent during 1980–86 to 9 percent during 1987–89. For its part, trade liberalization brought considerable changes in taxation. The income tax was reduced; the VAT was introduced; and quantitative restrictions on trade were replaced by declining (though still high) tariffs. The end of the 1980s was also helped by good weather conditions and generally favorable terms of trade. As a result, growth accelerated to an average 4.7 percent during 1986–89. Unfortunately, this rapid recovery was short-lived. In the early 1990s, a two-year drought and deteriorating terms of trade—resulting from falling phosphate prices and a sharp rise in oil prices arising from a Middle East crisis—led to a severe recession and more fiscal imbalances, thereby undercutting progress that had been achieved from the initial liberalization of the economy. Growth rates turned negative in 1992 and 1993, and they remained low for the rest of the decade.

The Bank's last CEM on Morocco—"Towards Higher Growth and Employment," written in 1995—addressed these issues. That CEM concluded that Morocco could achieve high, sustainable growth and employment again through an export-led growth strategy and a second generation of structural reforms. Those reforms included "deepened macroeconomic adjustment, added liberalization of the trade regime, labor market development—specifically higher and more efficient investments in human capital formation and reduction of rigidities—financial sector development and privatization." If these policies

were swiftly implemented, the CEM projected a doubling of growth rates to 6 percent in the medium term.

Delays in reform implementation until the 2000s have contributed to uneven progress. The high growth and low unemployment that was projected did not materialize. Between the mid 1990s and 2004, an expansionary economic cycle emerged. Growth reached an average of 4 percent between 2000 and 2004. GDP per capita grew at an average annual rate of about 2.3 percent. Although positive, this growth did not meet the high expectations of for the structural reforms, and performance remained below that of other countries in the MENA region. The impact of recovery on unemployment has been mixed. Total unemployment fell by an average annual of 1.6 percent through the 1995–2004 decade; however, because of steady rural migration to cities, urban employment fared worse than growth. The urban unemployment rate increased, especially among women and first time job-seekers. Not surprisingly, a significant number of workers left Morocco, especially during the early 2000s.

What has become particularly apparent, however, is the absence of an effective export-led growth strategy. Despite the application of several export-promotion policies—including fiscal incentives, customs facilitation, free trade zones, hard-currency facilities for exporters, and preferential trade arrangements—growth recovery is mainly attributable to the renewed dynamism of domestic demand. This was stimulated by strong tourism receipts and increased remittances from abroad, not export dynamism. A worrisome trend has thus emerged. While mild export growth averaged less than 5 percent during the current decade, strong import growth reached double digits. The predictable consequence of these trends is a historically high trade deficit—13 percent of GDP in 2004, a level that is projected to further worsen to 16 percent of GDP in 2005. This report explains why low export and modest economic growth rates are not only closely associated, but reflect deepening concerns about the current growth and export-promotion policies of Morocco.

The status quo is a high-risk option for Morocco. A wait-and-see approach hopes that growth might accelerate under present trends. Morocco's prudent macroeconomic policies and its sizable savings rate work in its favor. Several factors will certainly contribute to higher growth and lower poverty rates in the future—significant efforts in infrastructure facilitation, privatization, financial and public sector modernization, and signing of free trade agreements. Positive expectations are also supported by the 2000–04 recovery. Good agricultural years and a more dynamic nonagricultural sector encouraged the belief that Morocco was at last on a rising, sustainable growth cycle. Although such outcomes are indeed positive and encouraging, more recent developments have nevertheless underscored the limits of the wait-and-see approach. On one hand, the slowdown of the ongoing expansionary cycle in 2005 (when preliminary growth estimates are between 1.6 and 1.8 percent, following a severe drought) shows the economy's vulnerability to domestic shocks. On the other hand, the country faces significant external shocks—for example, the end of preferences related to the expiration of the Multi-Fiber Agreement, which is hitting Morocco's textile industry hard; weak growth in its main European markets, which might also affect remittance flows; high oil prices; and insufficient domestic and foreign private investment in a highly uncertain international environment, which might also affect tourism flows. Taken together, these factors would seem to make a wait-and-see approach risky indeed.

In its 2005 Country Assistance Strategy, the Bank recognized an inadequate understanding of growth in the past decade, and of Morocco's more general growth experience. For its part, the Government acknowledges the puzzle created by the deceleration of growth in parallel to the implementation of a broad reform agenda. Accelerating growth is critical for improving living standards. The evidence is overwhelming that growth is a main determinant of employment creation and poverty reduction. To make a dent on poverty, a developing country affected by income inequalities must make even more effort in terms of growth performance. Morocco is no exception. The country recently adopted a national strategy of human development (the INDH) as a top national priority. To succeed, this strategy will require both high growth rates and targeted spending on the poorest. Authorities must necessarily debate the best ways to reinvigorate growth—policies addressing domestic demand, or export-led policies to speed up structural transformation and deepen Morocco's reinsertion into international markets.

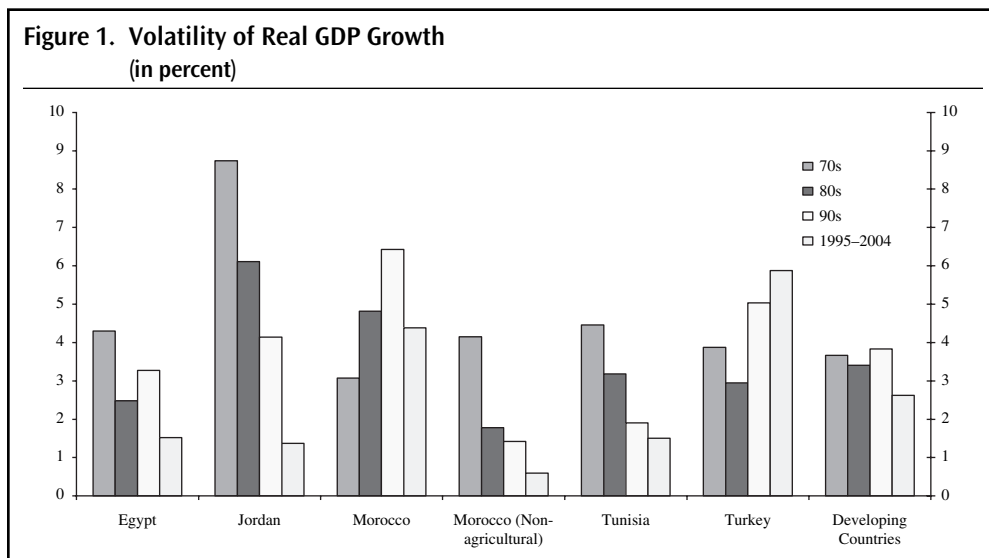
This report is structured in two volumes. Volume I draws the entire storyline. It summarizes the main findings from five chapters in Volume II ("Morocco CEM: Background Studies") while highlighting the major findings and conclusions that support its recommendations. As such, this Volume I report is self-contained. It opens with an introductory section on Moroccan growth in historical perspective and closes with a comprehensive policy proposal for growth and employment.

To some extent, each of the five chapters in Volume II is also self-contained. This allows readers who want greater depth on a topic covered in this report to focus down on the relevant chapter. To introduce some general findings on overall growth performance, Chapter I present stylized facts about Moroccan growth as well as a growth-accounting decomposition exercise. Chapter II, which is forward looking, comprises the core of the report. It develops an innovative growth diagnostic methodology to identify the main constraints to Moroccan growth in a step-by-step fashion. While developing its own analysis, the chapter also draws upon and integrates key findings from the remaining chapters. Chapter III reviews the investment climate of Morocco. Chapter IV focuses on international trade. Beyond conveying the importance of expanding exports, the analysis centers on anti-export bias. It underscores the need for clear understanding of the economic opportunities and challenges that the most recently signed trade arrangements will bring. Chapter V concentrates on the features of the Moroccan labor market and the challenges of employment creation. It closely examines its rigidities, labor costs, the relation between formal and informal employment, and the role of the minimum wage.

Morocco's Low Growth Rates in Historical Perspective

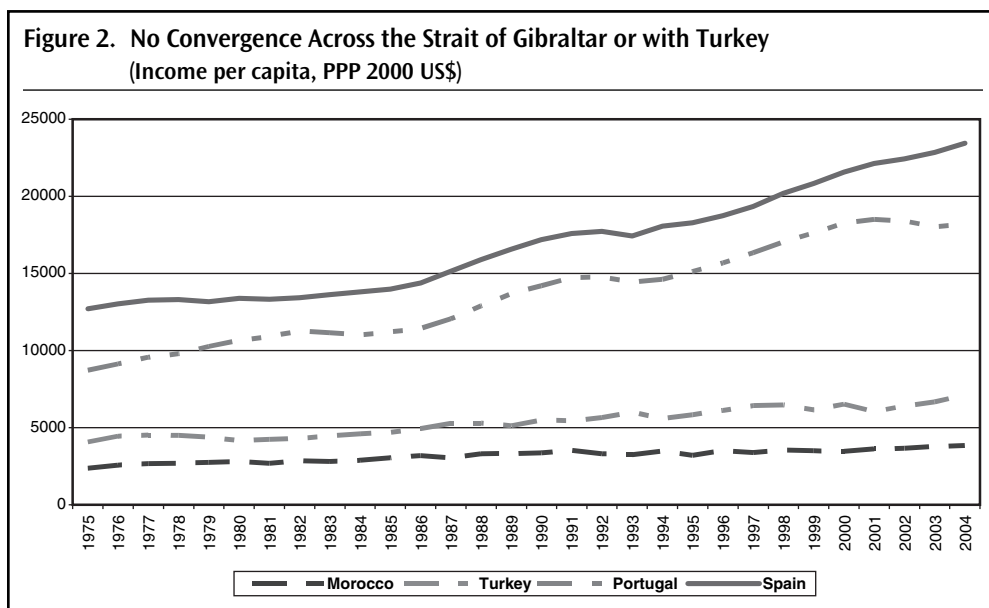
Morocco has had relatively volatile and weak growth in recent decades. Figure 1 presents average volatility of real GDP growth rates, defined as the standard deviation of annual growth rates observed during that decade. The figure compares rates for Morocco, some neighboring, and developing countries from 1970 to 2004. The comparatively high volatility in Morocco is related to the strong dependence of the Moroccan economy—its agricultural sector, in particular—on weather conditions. Non-agricultural GDP shows a much lower and declining trend in volatility over the same period. On average, developing countries featuring highly volatile growth rates also tend to show lower growth rates (World Bank 2000b). Growth performance is also weak, with a per capita GDP growth rate averaging below 2 percent during the same period (IMF 2005a). This is particularly worrisome because modest growth rates are not sufficient to significantly reduce unemployment and poverty.

Weak growth performance prevents Morocco from converging with richer neighboring countries or matching rates of emerging economies such as China. For 2002, the country is reported as having purchasing power parity (PPP) adjusted income per capita of US\$3,730. Just a few kilometers across the Strait of Gibraltar, Spain is reported to have an income more than five times higher, at US\$21,210. The European Union (EU) has an even higher PPP. In addition, there appears to be no trend toward closing this gap. Between 1960 and the mid 1970s, the differential between Spain's and Morocco's income per capita increased from about 3 to 5; then, following a decline until the end of the 1980s, the ratio widened again—above 5 since the 1990s (Figure 2). These findings are especially relevant taking into account that in the same period Spain (as well as France) belonged to a de facto integrated regional market for commodities with Morocco. The comparison with China is even more dramatic. Only 40 years ago, China

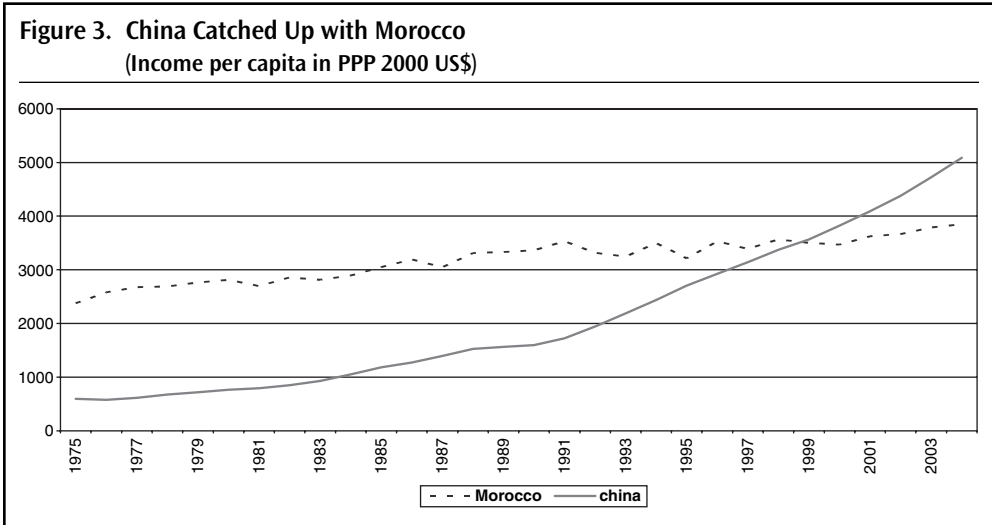


Sources: Moroccan National Accounts; and IMF staff estimates.

had a per capita income five times lower than Morocco. This relationship reversed at the end of the 1990s so that China now has 20 percent higher per capita income (Figure 3). The recent official report, “Fifty Years of Human Development,” also confirms the Moroccan economy is declining long-term growth trend since the 1960s (Baraka and Benrida 2006).

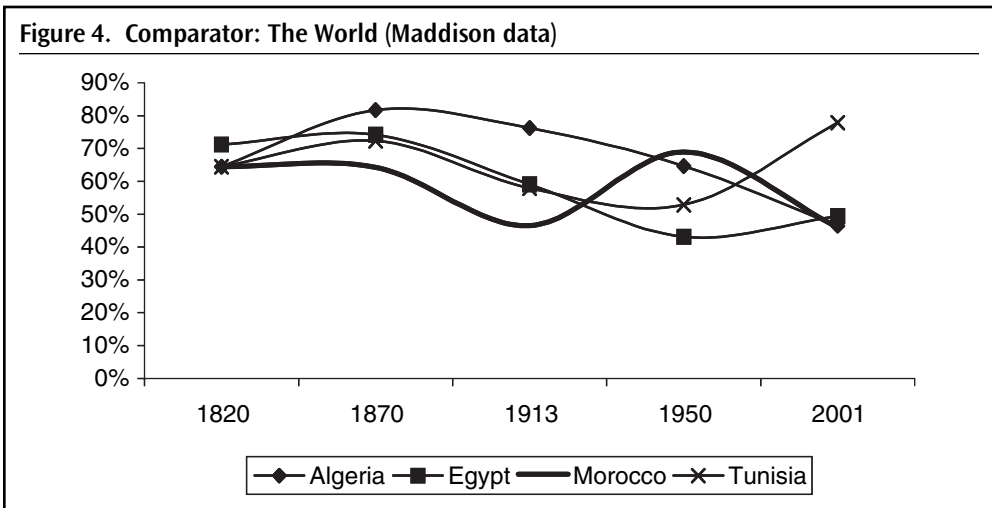


Source: World Development Indicators.



Source: World Bank DDP

From a much longer historical perspective, Morocco is also diverging from the rest of the world. Figure 4 depicts per capita income growth over nearly two centuries (Morocco and three other regional countries) with respect to the world (benchmark baseline of 100 percent). Despite significant fluctuations throughout the period, Morocco clearly diverges with respect to the world in the past 50 years. Results also suggest that the weak performance of Morocco is not uncommon with respect to two comparator countries: Algeria and Egypt. With one exception, the convergence (toward the world) experience of Tunisia since the 1950s, Morocco's (and Egypt's and Algeria's) relative position with respect to the world seems to be deteriorating in the long term.



Source: Madison.

These patterns suggest that Morocco's weak growth is not a recent phenomenon, despite the mild recovery in growth rates during the 2000s. Taking a long-term perspective, Morocco is clearly diverging from the world. Why growth is persistently low? What forces of convergence could reverse these trends? And how does low growth spillovers affect labor markets?

The Growth Puzzle: If the Fundamentals Are Good, Why Doesn't the Country Take Off?

The past outcomes are puzzling indeed. In the past decade, Morocco has enjoyed political and economic stability, deepened its democratic institutions, and (partially) adopted wide-ranging structural reforms. The country enjoys very favorable geographic proximity to one of the world's major markets. Indeed, the fundamentals are good. The macroeconomic environment has been stable along many dimensions: Inflation has remained low; the balance of payments has been positive; international reserves are high; and the public-debt-to-GDP ratio, especially external, is low and moderately declining. (For more detail on macroeconomic indicators, see Volume II.) Such developments should have led to a vigorous process of economic convergence with respect to its northern neighbors, as is happening in Eastern Europe and as has happened in Spain and Ireland with respect to the EU. Higher growth, however, has been elusive, and convergence is simply not there yet.

A misleading explanation is that GDP is not adequately measured due to multiple distortions in the still-prevailing national accounts system, which biases growth estimates downward. Without doubt, the current system underestimates the actual level of real GDP and, to a much lower relative extent, its rate of change. Yet this is far from an explanation of the long-term trends in growth rates that are depicted above. Box 1 describes shortcomings in Morocco's present national accounts, their implications, and multiple efforts to correct them. The series of the new national accounts are expected to be published during the second half of 2006.

There is no single approach to studying growth issues. In the past five decades, economic theory has moved from the neoclassical growth model developed by Solow (1956) to the endogenous growth model starting with Romer (1986). According to Solow, growth of per capita income occurs through interaction among three factors of production—capital, labor, and an unexplained residual measuring the efficiency of the economy, also known as total factor productivity (TFP). This is known as an exogenous growth model, because investment in technological progress is the force that raises the productivity of workers and expands the effective supply of labor. Extended Solow-based growth models have now split into two directions—first, growth accounting models (for example, the one shown in Table 1 in Chapter 3) and, second, cross-country regressions models.

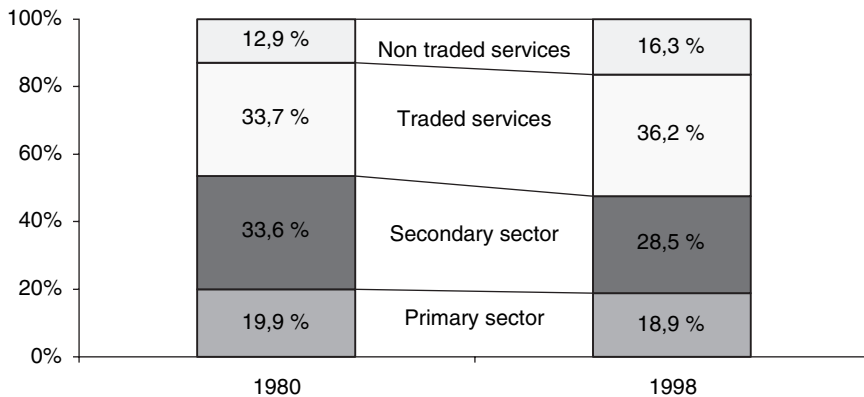
Romer's new theory introduces the key role played by externalities for growth. He finds that a constant exogenous rate of technological change is inadequate for explaining long-term economic trends. Instead, he proposes a model where externalities—for example, learning by doing and knowledge spillover that depend on investment by business firms (that is, are endogenous)—do positively affect the productivity of labor at the aggregate level (Helpman 2004). In Romer's model, the creation of knowledge capital is the

most important source of growth and innovations to the extent that they derive in productive investment and thus become the main source of sustained growth. In this CEM, the search for binding constraints to growth takes an approach that is consistent with endogenous growth models and the critical role played by knowledge capital in raising productivity.

Box 1. The Need for an Update of the National Accounts System

Since 1998, Morocco has been undertaking a large reform in an effort to update the Moroccan National Accounts System (MNAS) to the new United Nations Accountings System (UNAS), issued in 1993. Morocco's current national accounts, with 1980 as the base year, were constructed according to the UN system published in 1968. Though still in effect, major shortcomings make it obsolete. Because relative prices in the base year reflect relative production costs at that time, the MNAS does not reflect movements in relative prices over time, thus excluding structural and technological changes in the economy. In Morocco, however, significant change has taken place over the past 20 years, and new areas of economic activity have emerged. Under the present system, these are either nonexistent or underreported. To deal with MNAS shortcomings, Morocco carried out several studies in late 1990 and early 2000. These included an economic census (2001) and several surveys on the household standard of living (1998), the informal sector (1999), household consumption expenditure (2000), and public sector investment (2001). As shown below, preliminary results from the new 1998-based UNAS indicate that the primary and manufacturing sectors lost weight between 1980 and 1998 while the tertiary sector (services) increased its share by about 6 percent. So, the accuracy of the national accounts has deteriorated over time, as measurement errors over GDP and its components have reached nonnegligible amounts.

Sectoral Changes of GDP between 1980 and 1998



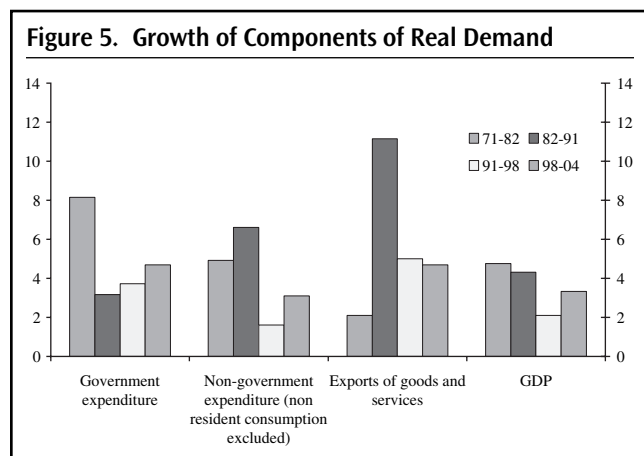
Source: Haut Commissariat au Plan.

The updated MNAS will have 1998 as the new base year. Under normal circumstances, the change of the base year alone would result in an upward revision of the GDP level, but without any major impact on its rate of growth. A key implication is that per capita income should increase. Accordingly, a first preliminary exercise made by the *Haut Commissariat au Plan* (HCP) shows that the 1998 nominal GDP is 11.5 higher than the GDP based on 1980. Furthermore, the MNAS updating concerns both the changing of the base year and the adoption of the new UNAS of 1993. The latter sets forth many improvements in terms of accounts coverage and disaggregations, and modifies the definition of variables. It is thus expected that while the level of most variables will increase, growth rates may vary as well.

Stylized Facts about Morocco's Growth

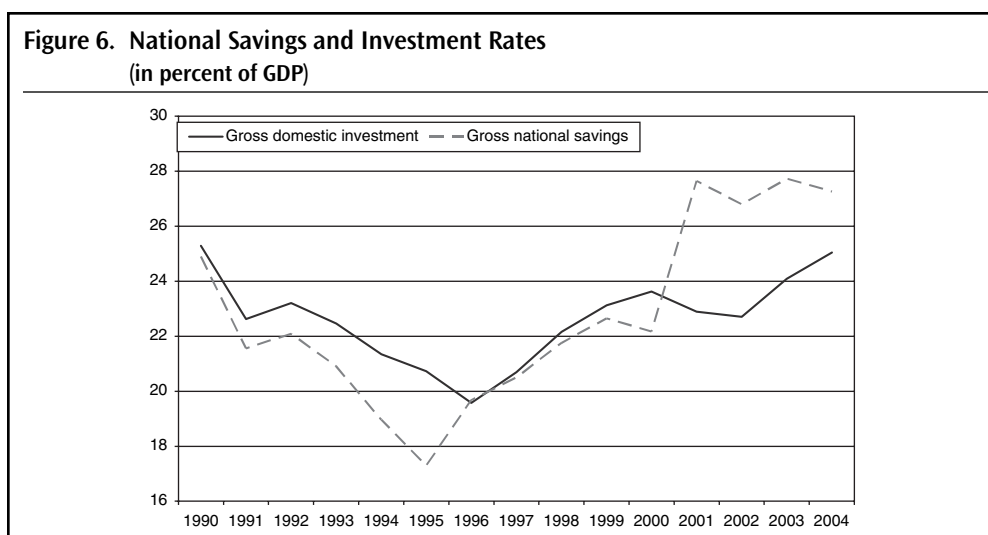
If anything beyond high volatility characterizes Morocco's supply structure, it is resistance to change. Indeed, the sectoral composition of GDP has not changed in the past 25 years. Agriculture continues to account for about 16 percent of GDP. The share of the industrial sector has not expanded significantly. Oscillating between 16 and 19 percent of GDP, industry remains essentially concentrated in three manufacturing exports: chemical, agrifood, and textiles and leather products. Services continue to prevail, with moderate recent dynamism in tourism, government, transportation, communications, and financial intermediation services.

On the demand side, however, two significant changes have occurred. First, in the 1980s the slowdown in domestic demand was counteracted by a remarkable expansion of exports in the context of continuous depreciation of the real effective exchange rate (Figure 5). The expansion in domestic demand came to halt in 1991 and has remained below the high level of export growth observed in most developing countries.



Sources: Moroccan National Accounts; WDI database; and IMF staff estimates.

Since the end of the 1990s, domestic demand has showed more dynamism than exports. This is explained in part by increased external savings (see below) and by social dialogue leading to indexed salaries to preserve the purchasing power of minimum wages in constant terms (see chapter VII). Second, propelled mainly by remittances from abroad and tourism receipts, the savings–investment gap shifted from a deficit 4 percent of GDP in 1995 to a significant surplus averaging 3.7 percent of GDP in 2001–04 (Figure 6). This gap would seem to indicate further room for investment in the economy. This investment could be financed by the excess savings (and banks have significant excess liquidity indeed!). Yet somehow, this is not happening.



Source: Direction de la Statistique, HCP.

A growth accounting model provides additional insights. Most important perhaps is that productivity growth, as measured by total factor productivity (TFP), has not contributed to overall growth over the past 35 years or over the last expansionary period (1998–2004). Table 1 shows that (a) TFP has been negative since 1991; (b) this negative TFP contribution is partly explained by the performance of the agricultural sector; and (c) low growth has essentially been driven by factors accumulation, with a slightly higher capital contribution (2.02 percent) than labor contribution (1.57 percent) over the most recent period.¹ As further capital is needed, the increase in foreign direct investment since the 1990s—rising from approximately nil in the 1980s to 1.7 percent of GDP (without privatization)—has also con-

1. Parameters found under growth accounting analysis are sensitive to the period chosen, but appear consistent with most other studies on this topic. To smooth out high variations between boom and bust years—especially necessary in an economy like Morocco, so often affected by drought—a rule of thumb is to define “cycle” as the period comprised between two troughs. Periods so selected are broadly similar to those in other analysis developed by and Ministère de Finance et de la Privatization (2005b). The former goes up to 1998 and also finds a negative TFP during the 1990s. The latter finds a negative TFP during 1990–2004, which becomes mildly positive when estimated over the 1998–2004 period. For different results based on different periods, see Baraka and Benrida (2006).

tributed to growth expansion. This rise, however, is insufficient. According to international experience, not only is a higher investment to GDP ratio needed. Reaching the authorities' GDP growth objective of a minimum of 5 to 6 percent in the medium term mainly requires productivity growth. The TFP growth tends to dominate changes in capital accumulation in explaining growth rates over the medium term (Easterly and Levine 2001).

Table 1. Growth Decomposition for the Whole Economy (in percent)

	1971–2004	1971–82	1982–91	1991–98	1998–2004
Real GDP	3.83	4.81	4.32	2.11	3.33
Contribution of capital	2.16	3.47	1.47	1.17	2.02
Contribution of labor	1.64	1.86	1.54	1.48	1.57
Contribution of TFP (as a residual)	0.03	–0.51	1.32	–0.54	–0.25

Source: IMF staff estimates.

Growth accounting analysis has well-known limitations. First, it is subject to data limitations, for example, data on rural employment only exist for the census years and for 1999–2004. This introduces some bias in the labor data used to estimate the production function of the growth accounting model. Measures of the stock of capital also vary according to the method used to estimate it. Second, “productivity” is estimated as a residual, not a direct estimate of the improvement in the quality or performance of production factors. Third, this “residual” is affected by uncertainties related to the measurement of production factors and output. An error in the estimate of capital stock or labor can significantly change the magnitude of productivity growth. Fourth, the estimating equation does not isolate the main factors that have contributed to productivity growth. Hence, there is no way to identify whether improvement in productivity comes from the quality of the capital stock, the quality of the human capital stock, the managerial or organizational skills of firms, or even from a source such as knowledge or innovations in a self-discovery process. Fifth, the share of each production factor is assumed to be constant throughout the period under consideration. This may not be the case for developing countries like Morocco, which typically tend to move from labor-intensive to capital-intensive activities over time.

A final limitation of growth accounting is that it does not provide detailed micro-sectoral analysis, which could be particularly relevant for sectors like agriculture or services. While manufacturing and services are mentioned in several chapters of this report, agriculture is deliberately omitted for two reasons. First, an Agricultural Strategy 2020 already exists (Ministère de l’Agriculture et du Développement Rural 2005). This strategy identifies key concerns that explain the low productivity of the agricultural sector. In particular, it points to factors that limit the competitiveness of small and medium-size farmers—price distortions, inefficient use of public funds, poor networking on commodity chains, and severe institutional shortcomings on land tenure and agricultural services. Second, proposals for the reform of the agricultural sector are the central topic of other recent Government and Bank reports (see Doukkali 2006, Sagou 2006, and World Bank 2003a, 2003b, 2003c). These proposals also point to the need for increased productivity and competitiveness. This

implies, first, gradual de-protection of agriculture, which would lead to shifts in relative prices and lower and better-targeted subsidies, and second, on the rapid modernization of the sector, with increased irrigation, research, technology, and new products.

Despite the aforementioned shortcomings, this analysis makes a significant initial contribution to the critical role that both augmented (private) investment and productivity should play in growth acceleration in Morocco. It also provides insights about the positive role that stabilization and selected structural policies might play (or not play) in further raising or sustaining productivity. Once growth accelerates, key structural policies will no doubt play a major role in supporting its sustainability. However, while remaining broad in its recommendations, the analysis does not answer the question of what triggers (or does not trigger) productivity and private investment. In other words, what ultimately prevents rapid growth from happening? The next chapter proposes one possible answer to that question.

The Binding Constraints to Growth in Morocco

At the outset, this report finds that the main binding constraints to growth are a specific combination of government and market failures leading to too little investment, entrepreneurial activity, and competitiveness, thereby hindering the structural economic transformation toward productive diversification. Productive diversification is defined as the transition from low-productivity to high-productivity activities. It particularly applies to the surge of export products and services that already exist in the world market, but are nevertheless new to the productive structure and expansion of external markets. This diversification process—which we also call “self-discovery”—is already taking place in Morocco. Indeed, innovative experiences are common, yet they are occurring more slowly, under severe handicaps in competitiveness, and with less significance than benchmarks in competitor countries. Government failures that partially explain low self-discovery include labor rigidities, high taxes on corporate businesses and on the hiring of skilled workers, the “fixed-peg” exchange rate regime, and the anti-export bias of the trade regime. These slow down the transition process and affect the competitiveness of Moroccan firms. Market failures that partially explain low self-discovery include coordination failures and information and learning externalities. Together, these failures produce an inadequate private appropriability for returns on investment. Similarly, governance constraints and perceived obstacles in the business environment, though not directly binding, also play an indirect and minor role in affecting private investment and entrepreneurship. Through their impact on growth, these shortcomings have an indirect impact on limiting the potential for employment creation. This chapter explains these findings.

In broad terms, growth strategies can be distinguished, depending on whether to accelerate the accumulation of factors of production, improve their private appropriability (that is, reduce the risk of expropriation of those factors or constraints to their adequate use) or

increase productivity. The first strategy focuses on increasing savings (both domestic and external), infrastructure, and human capital through higher spending on education. The second strategy develops a sound macroeconomic framework and minimizes microeconomic risks while improving governance and the rule of law. The third strategy focuses on the need for enhanced openness to external trade and foreign investment, complementary public investment, and protection of intellectual property. In implementing strategies, the perennial controversial issue is how active (*voluntariste*) the role of economic policy should be.

Growth strategies have produced lengthy lists of standard structural reforms. These sometimes all-inclusive agendas are typically based on several assumptions—first, that every reform is good by itself; second, that the deeper the content of reform, the better; and third, the more sectoral measures, the deeper the reforms. The difficulty with these approaches is their debatable economic rationale.

Empirical evidence, however, shows that growth accelerations are only weakly related to major economic reforms. Hausmann, Pritchett, and Rodrik (2004) study growth accelerations, defined as average per capita growth above 3.5 percent during 8 years, and representing at least a 2 percent rate above the preceding 8 years. They find episodes of major economic liberalizations are followed by significant growth accelerations in only 18.2 percent of 83 cases between 1960 and 2000, less than 20 percent of their sample. Growth accelerations are followed by negative or slow growth in about 40 percent of the cases. Hence, the fact that a significant liberalization process has not been followed by an acceleration of growth—for example, the path partly followed by Morocco since the 1980s, interrupted in the 1990s, and restarted in the 2000s—is not uncommon. The work on growth accelerations suggests that these periods are triggered not by wholesale reform but by smaller changes that relax the binding constraints on growth and thus unleashing periods of sustained growth. In this light, it would appear that many of the reforms undertaken by Morocco may have improved secondary aspects of growth dynamics, but the binding constraints on growth were not significantly affected.

Findings such as these justify the present CEM approach, which applies an innovative and comprehensive growth diagnostic to identify the main binding constraints. The diagnostic follows a discriminatory procedure presented in seminal work by Hausmann, Rodrik, and Velasco (2004). It looks comprehensively at all bottlenecks that might potentially prevent growth from taking off from a transversal, not sectoral point of view. The procedure starts from an exhaustive overview of all possible “factors of production.” Which have the potential either to augment or counter growth? What are their interactions across distorted markets? Then, it selects those factors that seem to have a large positive impact on growth. It downplays those with less significant or negative effects. The diagnostic is grounded in the basic economics of growth—the incentives of the private sector to invest, adapt new technologies, and seek new products. Thus, it does not assume that exogenous factors such as technological change explain long-term trends in growth. Instead, it follows an endogenous model in acknowledging that the accumulation of capital by the private sector is the factor that ultimately determines growth, but pointing to the key role that negative externalities may play in constraining investment decisions, knowledge, innovations, and productivity.

Growth diagnostics assumes a simple growth model whose broad production function depends on several factors subject to be constrained, $Y = f(\text{capital, human capital, institutions, geography, infrastructure, productive diversification (self-discovery), and so forth})$.

The approach is formalized in a theoretical model fully developed in Hausmann, Rodrik, and Velasco (referred to as HRV), 2004.² In the HRV model, these factors are assumed to be complementary; and all of them matter for growth. The challenge is to identify which ones have the highest marginal return—which is indicative that they are binding—and, by extension, that their policy change would have the greatest beneficial impact on growth. Thus, two important rules of thumb follow. First, factors of production that show high shadow prices (rates of return) may be considered as binding constraints to growth, while they lower the shadow price of other factors which should be discarded. Second, changes in the supply of a binding constraint should have very large effects on growth, while changes in the supply of a factor that does not bind would not.

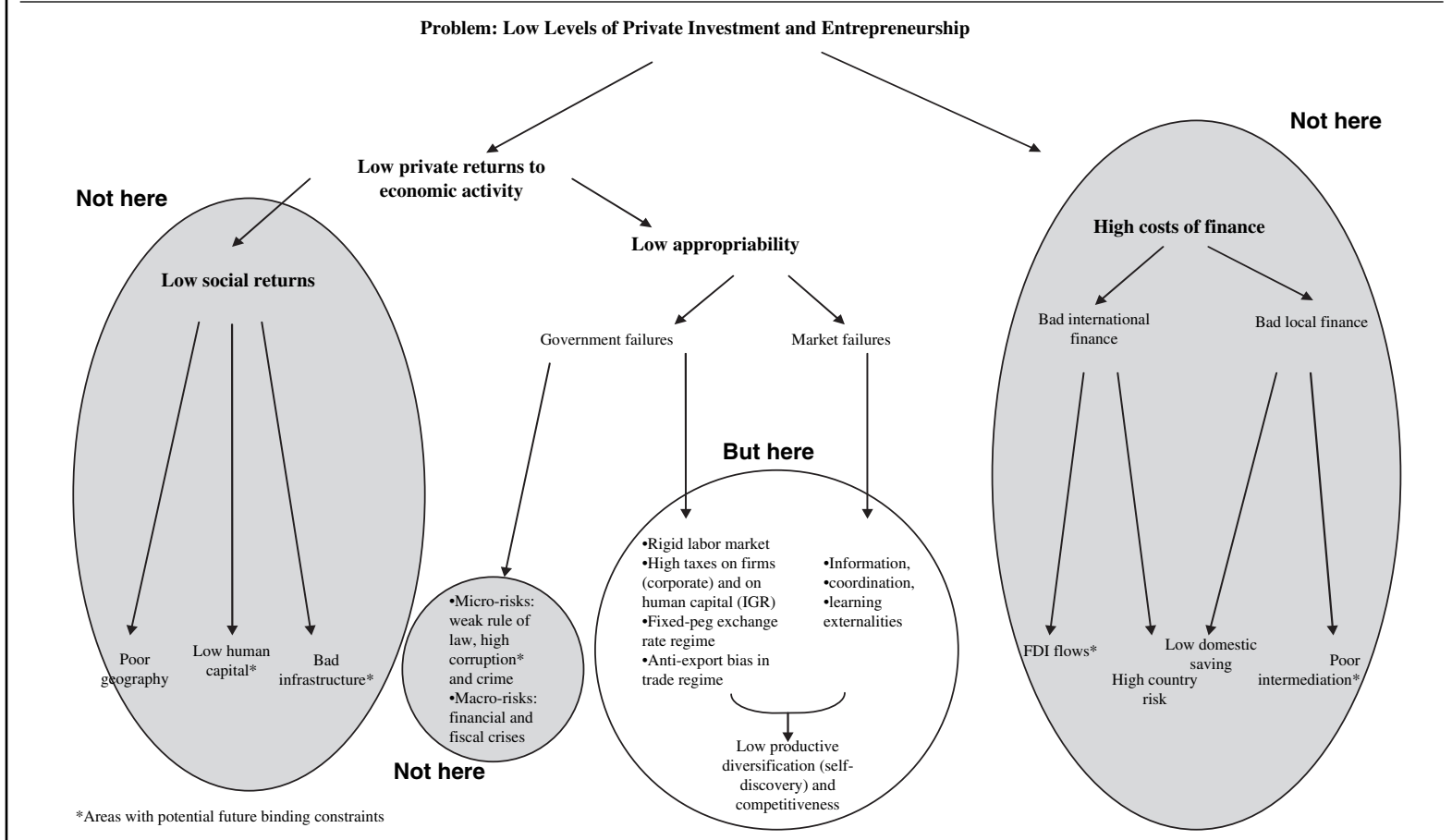
The growth diagnostic approach offers three significant advantages. First, it is *country specific* in its assuming that a similar growth strategy targeted at different binding constraints for all countries, regardless of their circumstances, is unlikely to prove productive. Second, it is *comprehensive* in its diagnostic and selective in its policies. It does not overwhelm governments with a long list of reforms. Instead, it recommends a reduced but more targeted agenda. Third, it is *heterodox*, because the removal of the main binding constraints might combine sound economic principles of orthodox reforms with less-orthodox policies, often based on second-best options. Take, for example, subsidies that drain fiscal resources but still do not achieve their desired economic and social effects unless they are well targeted and transparent. Designing growth strategies using growth diagnostics recognizes the uniqueness of country conditions, the scarce political capital available for policy reform, and the market and government failures that sometimes rule out first-best policy options. Governments should therefore choose from a limited set of policy reforms most likely to maximize direct effects, that is, those that alleviate the binding constraints to growth. In this spirit, the recommendations in this report are necessarily selective.

On the other hand, the growth diagnostic approach has three significant disadvantages. First, it is *static*, for it considers the steady-state solution to the dynamics of constraints that may be binding today but not necessarily in the future. For example, a gap in roads infrastructure might not be binding today, but it might become binding once growth accelerates. Second, by the same token, it *does not consider the sequencing of reforms* among present and future binding constraints. Third, facing data limitations, it *has difficulties to finding direct measures of shadow prices* (rates of return), which are often needed to assess whether or not a constraint is binding, thus forcing the diagnostic to rely on theoretical grounds or indirect evidence. This report minimizes these disadvantages.

In practice, growth diagnostics follows a discriminatory procedure of potential shortcomings that can be designed in a decision tree (Figure 7). Thus, the procedure first defines a set of potential binding constraints, associated with all possible factors of production, but regrouped under three categories. *Financing constraints* are low domestic savings, poor intermediation in domestic financial markets, limited access to external financial markets or low foreign direct investment. *Low social returns to factors of production* are insufficient investment in complementary factors like human capital, insufficient infrastructure, or poor geography. *Low private appropriability* are high macro and micro risks, inefficient tax structure or high tax rates, poor property rights and contract enforcement, too little product

2. For a full algebraic presentation of the HRV model, see the appendix in the HRV paper.

Figure 7. Growth Diagnostic: Decision Tree on the Main Constraints to Growth



Source: World Bank staff elaboration based on HRV 2004.

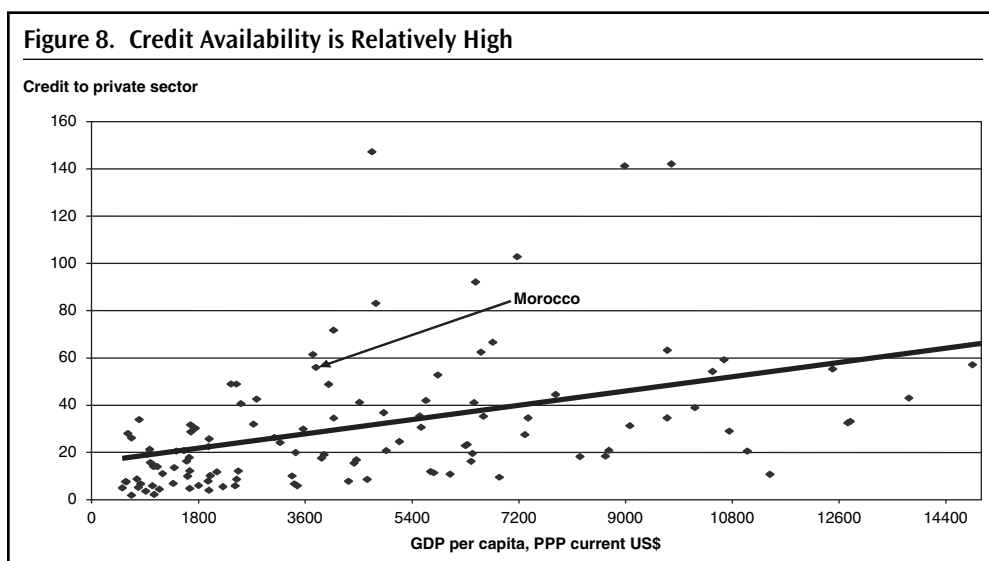
innovation or self discovery, or large externalities. Second, the procedure examines each potential binding constraint to determine its validity. This implies detailed examination of candidates in the decision tree. In moving through the branches, non-qualifying constraints are sequentially discarded until a few remaining choices are left under the category of low appropriability. These are the choices that merit the most attention from policymakers. We also indicate constraints that could be potentially binding in the future. A starting question therefore is whether the problem is high cost of finance.

There is overwhelming evidence that Morocco's low growth is not constrained by domestic financing. The country increased its savings rate in the past decade by about 9 percent of GDP. Nevertheless, its investment rate went up by only 4 percentage points, reaching a non-negligible, still average investment rate of 25 percent of GDP in 2004. Excess national savings can be attributed to an improved macroeconomic environment, higher remittances and tourism receipts, better opportunities for financial savings, and a rather mild increase in public savings. Furthermore, there is low return on capital. The real interest rates on deposits or on lending is positive, very low, and declining. Real interest rates are below 10 percent, that is, very low in international terms and certainly lower than Morocco's main competitors—Turkey, Poland, and Romania (except China). This reflects an improvement of local finance conditions. It suggests that the banking sector is willing to place more resources than agents are demanding because of limited investment opportunities. In similar terms, credit availability is higher than would be predicted by Morocco's income level (Figure 8). Basically, the economy has ample and unused access to domestic savings at interest rates that are low and decreasing, which would have support growth acceleration had it actually happened.

Past general findings merit an important caveat: Small and medium enterprises face important constraints in access to financing. SMEs can become very important in the promotion of new export activities, particularly in emerging new sectors like ICT, *artisanat*, and agri-foods. However, the Investment Climate Assessment (ICA) survey shows in detail how the small percentage of firms that have no access to banking credit (about 16 percent of those surveyed) are concentrated in small and medium firms. SMEs are not particularly responsible for a significantly high number of default loans in the banking system. Rather, data from the Banking Superintendency reveal the strong concentration of default loans in large and medium-to-large firms. In 2004, 3.6 percent of lenders, holders of large loans above MAD15 million, were responsible for 47.3 percent of default loans. Nearly half (48.5 percent) of lenders—holders of mid-to-large-size loans between MAD1 million and MAD15 million—were responsible of 43.9 percent of default loans. Thus, the SMEs, main holders of loans below MAD1 million, are excluded from both categories, while representing about 48 percent of remaining lenders and less than 9 percent of default loans. This outcome still does not prevent SMEs from facing tougher conditions than larger firms before obtaining access to formal credit. In general, they pay higher interest rates—associated with higher risk premiums—and higher guarantees. The severity of such conditions justified the creation of alternative financing mechanisms.³

3. The list of available resources for SMEs is particularly extensive and includes the MEDA program and Euro-Mediterranean Facilities for Investment and Partnership (FEMI) programs of the EU; the Support Program to Moroccan Guarantee Institutions (PAIGAM), the Fund for Textile Restructuring (FOR-TEX), the Fund for Tourism Restructuring (RENOVOTEL), the Mise a Niveau Fund (FOMAN), the De-pollution Fund (FODEP), and the commercial banks' credit lines (Group BMCE, Popular Bank, Att-jariwafa Bank, Credit Agricole, and so forth).

Nonetheless, authorities recognize that the environment created to promote SME access to financing has performed poorly (Ministere de Finance et de la Privatization 2003). Such performance features include declining credits to young entrepreneurs; predominance of very small loans (below MAD1,500) to SMEs; inadequacy of certain financing mechanisms proposed, including capital risk financing for SMEs; little use of the stock market; and weak use by SMEs of existing bilateral credit lines (French, Spanish, Italian, and Portuguese) and guarantee funds (no less than nine funds). These findings amply confirm that alternative financing resources are available to SMEs. Their limited use is explained by factors such as the lack of transparency in their financial statements, and possibly because of small size of loans, limited interest within the formal banking system in actively promoting their activities.

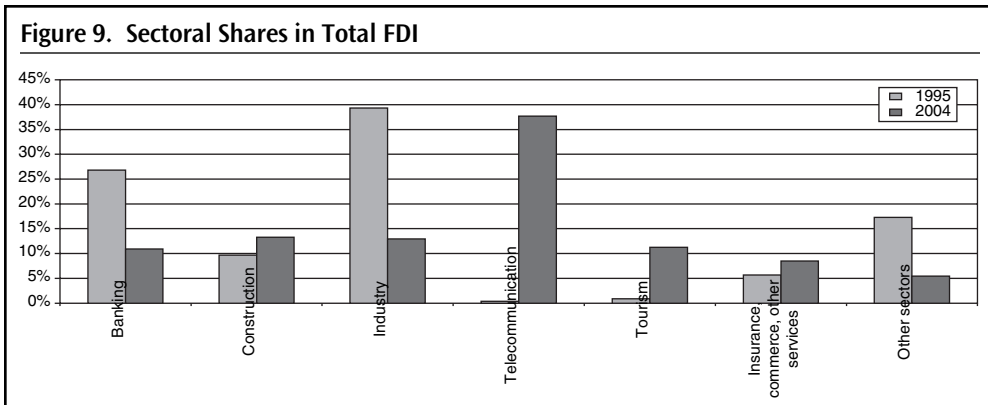


Source: WDI.

In similar vein, Morocco's growth is not constrained by external finance conditions. Moroccan FDI inflows are growing rapidly and shifting into the new sectors of telecommunications, tourism, and insurance services (Figure 9). FDI has actually increased from less than 1 percent of GDP at the end of the 1990s to an average above 4 percent of GDP during 2003–05, as the country has become the fastest growing recipient of FDI flows in the MENA region. About a third of inflows during 2001–04 corresponded to privatization receipts and some key sectors—including banking (particularly in portfolio investment), transport and manufacturing services—remain relatively “closed” to FDI.⁴ It remains to be seen whether these inflows will continue to grow as a steady trend. Similarly, low (below average EMBI plus spreads) and declining spreads in the ratings of Morocco's country risk

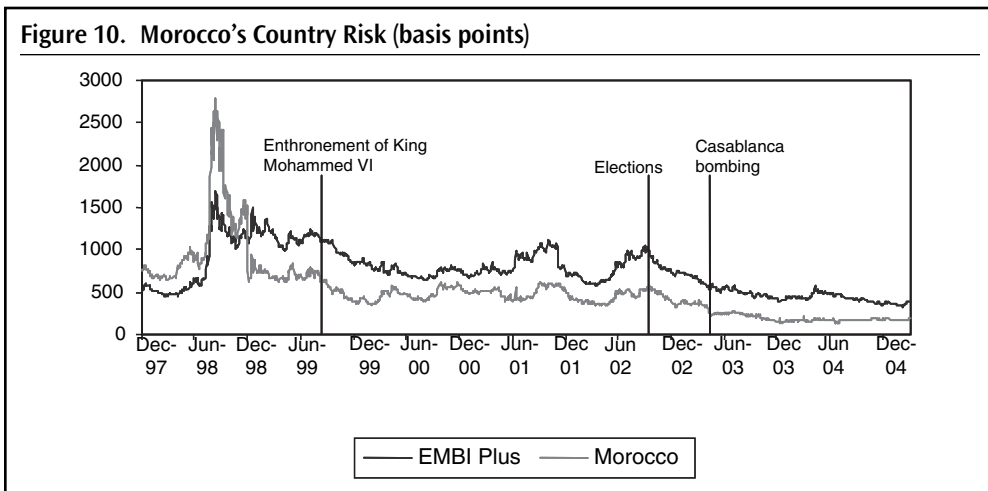
4. An illustrative case is the FTA signed with the United States in which Morocco obtained the right to prevent takeover of any Moroccan bank by a foreign bank, and the right to issue restrictions on market access to new financial services.

indicate that the country encounters little problem in access to external capital markets. Morocco is one step below investment grade (Figure 10). These findings lead to the conclusion that financing constraints are not the problem, but rather, low private returns to investment. This poses a second question: Is the problem low social returns?



Source: *Office des Changes*, Government of Morocco.

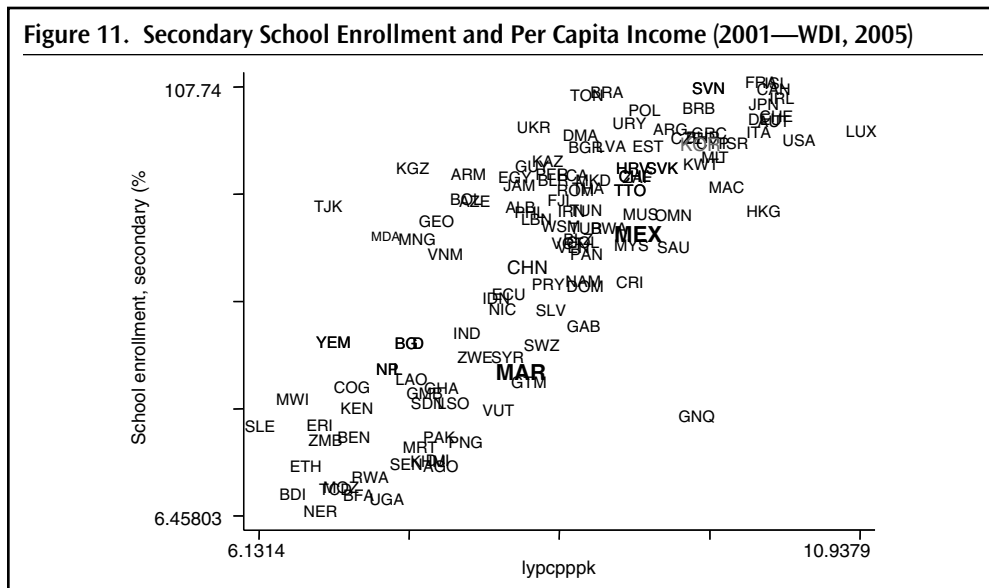
Low growth is also not explained by low social returns related to low human capital accumulation. High social returns are good for growth. Well supplied human capital increases returns to physical capital accumulation because both factors are complementary to each other. High returns to education would mean that the economy is gobbling up its scarce supply of educated people and willing to pay a hefty return to the educated few. Morocco already spends more than 6 percent of GDP on education, which is average; and it would be expected to show high returns to education for its corresponding level of income per capita. However, this is not the case. Instead, quantitative estimates of returns



Source: EMBI database.

to education from a standard Mincer⁵ regression show modest results. At an annual rate of 11 percent for the urban population, returns to education are comparatively low by international standards. This rate is lower than that of Brazil, which has about the same schooling rate; and it is below Chile and the United States, which have higher schooling rates. In addition, estimated Mincer rates are not different for men and women. More important, they *declined* in the past decade. These results are also consistent with the high unemployment rates for workers with higher levels of education and with the low levels of education prevailing among workers in manufacturing firms. Barely 9 percent of Moroccan workers have completed secondary studies, according to ICA findings. The small endowment of qualified human capital among firms should also be a reason for higher returns to education than they appear. As this is not happening, one concludes that different factors in the labor market must be acting as disincentives to accumulation.

Previous results are even more surprising in regard to secondary enrollment, where Morocco appears to be an underperformer (Figure 11). Ensuing low tertiary enrollment means that even if Morocco has a low educational supply, its returns are low.



Source: WDI.

In a normal economy, this low educational supply should generate very large returns to schooling. However, that is not the case in Morocco. Why? One possible explanation is that very high taxes on skilled professionals, could constitute an expensive tax for firms deciding how to use human capital. This possibility is considered below. Another possible

5. Mincer rates are estimated following the method of Jacob Mincer, a professor at Columbia University in New York. The regression model is $\ln \text{ wage} = f(\text{age}, \text{age}^2, \text{ and dummies for gender and completed primary, secondary and tertiary education})$. The estimated coefficients represent the rates of return of investment on the corresponding level of education (opportunity cost). Detailed estimates are found in Volume II, paragraph 2.30 of this CEM.

explanation is that the quality of secondary and tertiary education is so poor that returns simply correspond to its low level. In fact, this is partly true. Certainly, the country has much room to improve educational quality (and indeed, a reform of superior education is underway) and the labor productivity of graduates once hired. In addition, reform is improving the matching process between education skills and firms requirements. Yet it is also true that most Moroccan universities provide an acceptable level of education; and as a matter of fact, a significant number of professionals and skilled workers are able to find better-remunerated job opportunities abroad.

In short, growth trends are not primarily constrained by inadequacy in human capital. Rather, the *demand* for highly skilled labor is simply not there. Because Mincer rates are sensitive to growth and because higher returns to education are associated with higher rates of growth, an argument could be made that the country's considerable recent effort in education poses a major challenge—to create growth and employment opportunities in order to make effective use of the investment, lest the country loose its better educated young people to unemployment and emigration. This is so because returns to education are low, unemployment of better educated workers is high, and improvements in educational attainment will support higher returns only if growth materializes

Growth is not primarily constrained by geography or poor infrastructure. If anything favors Morocco's growth, it is proximity to the European markets—particularly Spain and France, with which it even has a structural dependence. However, in order to take full advantage of geography, the quality of transport and trade logistics must constitute a central element of competitiveness. Moroccan exporters can successfully exploit their proximity to the large EU market, but only if their trade transactions costs are indeed lower than those of their competitors.

The importance of well-functioning links across supply chains is further increased by the shift toward just-in-time delivery schedules and demanding trading partners who are increasingly concerned about timing, reliability, and quality of deliveries. As seen in the findings of the ICA survey shown below, barely 1 out of 8 firms complained about customs procedures, and only 1 out of 20 firms mentioned transport needs as a major constraint. Electricity and telecommunications are also relatively less-relevant constraints operating upon the business environment. In a similar vein, if infrastructure were the binding constraint, improvements would be expected to have a very large effect on growth. This does not seem to be the case however. The country actually made very significant progress on infrastructure over the past decade. According to the *Global Competitiveness Report*, Morocco's telephone, electricity supply, and postal services are ranked among the top 40 countries. Telecommunications has been successfully privatized, and its costs have declined significantly. Railroad and air transportation are ranked at the mid-point in world terms, and they keep improving. The road network is expanding (see Volume II, Figure II.7). Those general and solid findings have, however, an exception. In a World Bank study (2005b), port charges and sea shipment costs are identified as excessively high. The cost of port passage and merchandise handling at Casablanca are the highest of the Mediterranean Sea (US\$247 and US\$147 per 20" Equivalent Vingt Pieds container). In the similar vein, the cost of transport from Agadir to Spain is tantamount to the cost from Istanbul to France. Crossing 15 kilometers across Gibraltar to Europe is equivalent to the cost of surface travel across Spain, a distance above 700 kilometers. These particular logistics constraints obviously require specific and urgent solution.

Nevertheless, in light of the major outcomes described above, poor infrastructure and geography can not now be considered among the main binding constraints to growth. This does not mean that additional investments should not continue. Infrastructure, just as education, is an essential element to sustaining growth. Once growth takes off, gaps might become a binding constraint at a later stage of development.

The remaining component of the decision tree hints about the importance of low appropriability constraints. In this case, low private returns to investment may be due to:

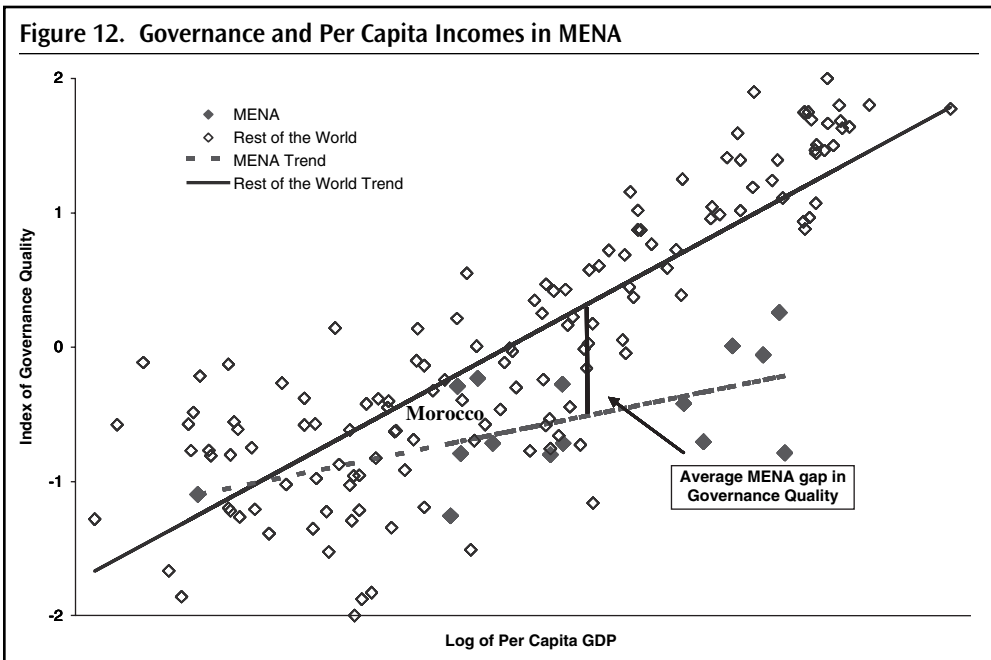
- high macro and micro risks;
- other government failures referring to high taxes on firms and on the hiring of human capital, labor market rigidities, a “fixed-peg” exchange rate regime and an anti-export bias (the latter three equivalent to *de facto* implicit taxation);
- market failures in coordination, information, or training externalities.

While the high macro and micro risk constraints can be excluded, the two constraints that follow are binding and intrinsically related to the lack of productive diversification (or too little “self-discovery”) and low competitiveness.

Low growth is not a direct consequence of macroeconomic instability. Morocco’s macroeconomic stance is sound and macro risks are low (see Chapter I in Volume II, and IMF 2005a). Moroccan debt spreads in capital markets—a measure of the risk perceived by investment agencies—is among the lowest in emerging markets. The long-term decline speaks well for the management of the country’s macroeconomic policies. The country has not experienced a borderline currency crisis since the early 1980s, when the current account deficit reached above 12 percent of GDP and foreign exchange reserves covered less than a week of imports. The economy has weathered well through external shocks, including successful prevention of contagion from turbulences in international capital markets during the past two decades. At present, the external current account shows a small surplus. The fiscal deficit and public debt ratios are of concern, but they are sustainable. They should improve as the Government has adopted measures to reach their respective targets of 3 percent of GDP and 65 percent of GDP in the medium-term.

Microeconomic risks are also low and often associated with governance. In general, this is acceptable; although careful attention should be placed on the level of corruption, which could become an important binding constraint in the future. When compared to the world, we estimate that Morocco displays an average level of governance quality as would be predicted by its income. The governance gap with respect to its peers in the world—the vertical distance with respect to the regression line in Figure 12—is minimal. In addition, when compared to the average MENA indicators, Morocco outperforms them. What creates such a small gap? In general, it is symptomatic of weaknesses either in the quality of public administration or in public accountability. Morocco scores reasonably well in quality of public administration compared to countries at similar income levels; however, it falls short in public accountability. World Bank governance (Kaufmann and others, 2005) and Doing Business (2005—see Annex II.A4 Volume II) indicators provide similar findings, including scores on contracts enforcement reflecting the degree of Morocco’s respect for the rule of the law. The country has, however, a potential major constraint. Despite average scores in corruption rankings worldwide by Transparency International (clearly better than most MENA and African countries), Morocco’s 2005

Corruption Perception Index is 3.2. This value is slightly above the 2.5–3.0 range, the threshold for countries suffering from rampant corruption at levels that frighten off foreign investment. Even more worrisome is the trend. Morocco fell from 37th place in 2000 to 78th place in 2005. Prompt reversal of this trend requires urgent action of the sort recently announced by the Government—designing an anticorruption strategy and creating a strong independent body in charge of implementation. Finally, Morocco ranks among top countries with lower crime problems. According to recent comparative reports, there are no patterns of high crime rates reported for Morocco. Even after the Casablanca bombings in 2003, security concerns did not prevent tourist flows from recovering within a few months. In short, macro and microeconomic risks are low; however, preserving sound fundamentals—especially on fiscal balances and public debt, and in fighting corruption—will be essential for higher growth under any circumstances.



Source: Anós Casero and Allen (2004)

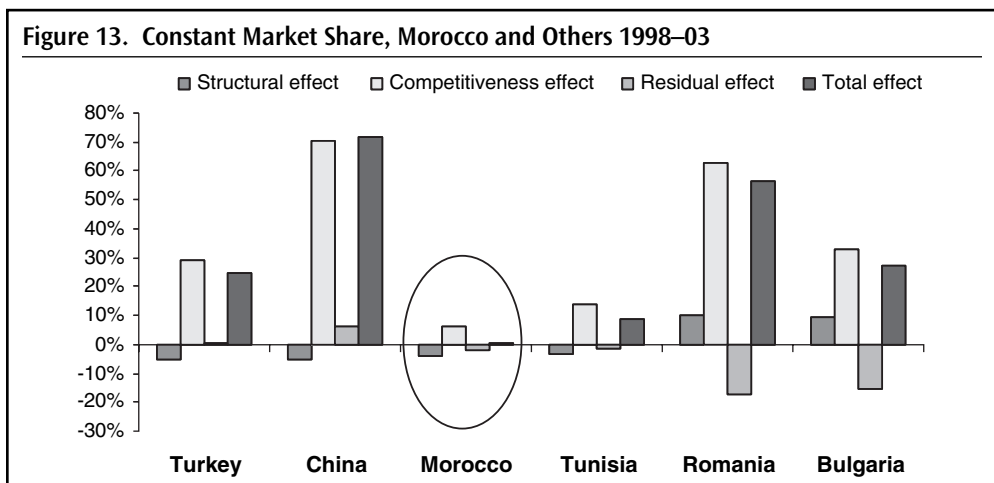
Evidence shows that the binding constraints are a particular combination of other government and market failures. These lead to low productive diversification and competitiveness (as well as insufficient investment) by the private sector. Following the decision tree (Figure 7), we find a particular combination of low appropriability constraints that binds Morocco's self-discovery process moving from low-productivity to high-productivity export activities with enhanced competitiveness. Indeed, the process of development involves moving toward higher productivity activities. Richer countries produce goods that are different from those produced by poorer countries. Development involves identifying and learning to produce goods that are more like those of richer countries. That is what productive diversification is about.

The decision tree also suggests several constraints that might not be binding now but could become so once growth accelerates. Past findings refer to the present situation but say little about constraints that could be binding later, potentially overlooking discussion on proper sequencing among proposed growth-acceleration measures. Our growth diagnostic also identifies five constraints that might become potentially binding in the future but may require action now—low human capital; logistics problems in expensive shipment costs; worsening corruption; still-low, non-privatization-related FDI flows; and poor financial intermediation in facilitating access to SMEs. The rationale for this selection is multiple. On *education*, it is obvious that the country still has important shortcomings in literacy and secondary and tertiary enrolment rates. Coupled with the increased share of skilled workers moving abroad, these shortcomings pose a significant challenge once sustaining growth accelerates. On *logistics* issues, there is no doubt that high port charges and sea shipment costs—just to mention those that are more relevant—are major factors in the future competitiveness of Moroccan exports. Considerable reduction in those costs is expected by the private sector once the new Tanger-Med port becomes operational. On *corruption*, the country has no alternative but to reverse its slippage in the direction of lower international rankings. Otherwise, Morocco could join the unenviable list of countries that motivate foreign investment flows to move elsewhere to “healthier” places. On *low FDI flows*, Morocco has encouraging patterns. However, a major effort is still needed to promote the local assimilation of the know-how that accompanies FDI resources, as well as its importance in explaining the rapid growth in East Asia and other fast-developing economies. Finally, on *poor financial intermediation facilitating access to credit by SMEs*, it should be remembered that SMEs are critical for maintaining rapid development of new discoveries, especially since these tend to develop in SMEs with relatively lower capital than larger firms. Therefore, sustaining rapid growth will require adequate financing to promote the creation and expansion of SMEs.

In order to fully grasp the interactions between the binding factors, a stepwise approach is needed. In a *first step*, we demonstrate the limited degree of export diversification and, more formally, self discovery of Moroccan exports. At first glance, this might appear simply as another stylized feature of the Moroccan economy. Yet to do so would ignore evidence about growth accelerations, which shows the direct relationships among the composition of export supply, discovery activity, and growth. In other words, what matters is not *how much* but *what* you export (and the speed at which you do it). If Morocco had a more diversified export supply, it would certainly increase its probabilities for higher rates of growth. These findings are critically important, but they still do not answer the harder question that follows: What ultimately prevents productive diversification from happening? Therefore, in a *second step* we identify the mix of government and market failures that prevents productive diversification and limit competitiveness and, by the same token, growth acceleration. The results are straightforward. On the one hand, four government failures are particularly binding—labor rigidities; high taxes on firms (corporate) and on the hiring of human capital (the IGR); the “fixed-peg” exchange rate regime (given the tight labor market conditions), and the high anti-export bias in the trade regime. These factors each reduce competitiveness in a macroeconomic equilibrium that is prone to low growth and high unemployment. On the other hand, coordination, information and learning externalities are found to be the market failures responsible for slowing down the transition process.

First Step: The Close Relationship between Export Diversification, Self Discovery, and Growth

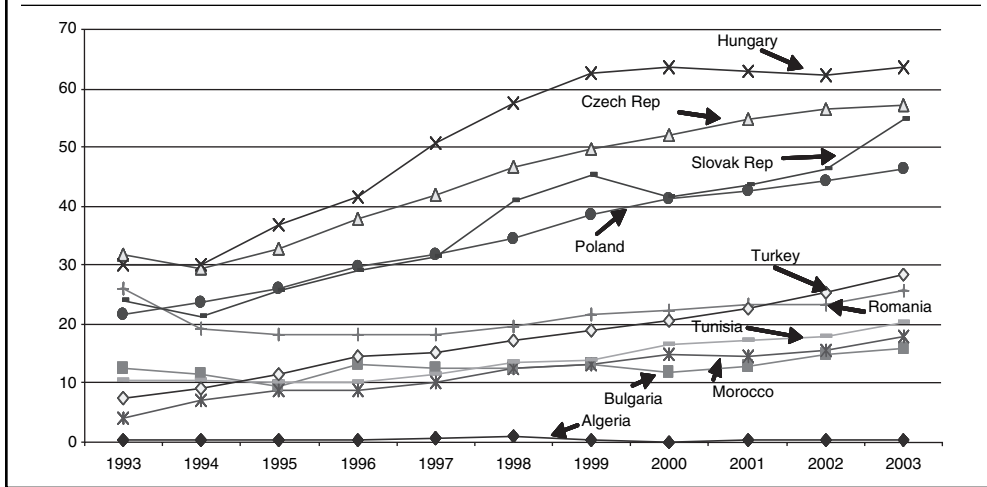
Several key indicators point to the low and slow diversification of Moroccan exports. The top 10 products account for almost 80 percent of Moroccan exports. In a very robust finding to different data disaggregation, a first indicator, the Herfindhal index—which ranges from 0 to 1, with lower values indicating greater diversification of export earnings—shows that Morocco followed a very steep downward diversification trend during the late 1970s to mid 1980s but then remained constant in the 1990s, only continue mild decrease in the early 2000s (see Volume II, Chapter II). As a result, Morocco remains with the highest Herfindal index among its main competitors in the EU market. A second indicator is obtained from a technique known as constant market share analysis. Figure 13 shows that the recent very low export growth of Morocco has been driven by its ability to raise market share (small competitiveness effect) rather than by its capability to expand in exporting products that are growing fast (negative structural effect). A third indicator is the share of exports of goods accounted for by engineering and other high-value-added manufacturing products. While the ratios of countries in Eastern Europe have substantially increased, these increases are much milder in the case of Morocco, with less than 20 percent of total exports being more advanced manufactures (Figure 14). Such lack of diversification is compounded because key exports tend to be products that are not dynamic in terms of growth of world demand. In sum, the existing product structure of exports has been a constraint on export growth, and reducing barriers that limit diversification into new products is likely to be necessary for strong export expansion in the future (World Bank 2005d).



Source: World Bank, 2005d.

It is nevertheless possible to go one step further and estimate the relationship between the level of sophistication of exports and income per capita. Hausmann Hwang and Rodrik (2005) measure the level of sophistication of a country's exports as the weighted average of the income per capita of countries exporting its basket of exports. They proceed in two steps.

Figure 14. Percentage Share of Engineering and Other High-value-added Manufactured Products in Total Exports



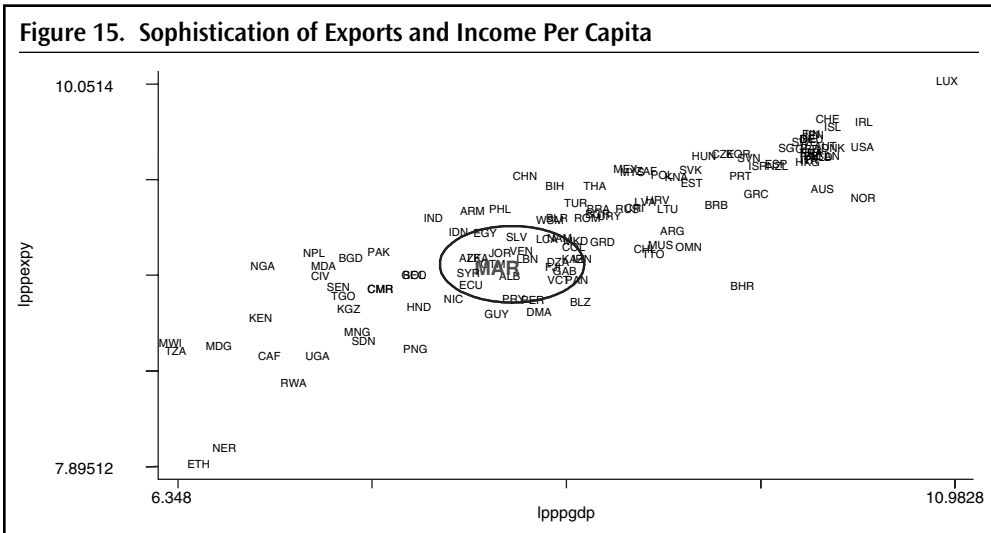
Source: World Bank 2005d.

First, they calculate for each product the average of the GDP per capita of all countries exporting that product. This reveals an “implied” GDP per capita associated with each product. And, second, by adding the weighted average of implied GDP per capita of each product belonging to the country’s basket of merchandise exports. This weighted average represents the level of sophistication of its exports.

Figure 15 illustrates the positive relationship between the level of sophistication of a country’s export basket and its income per capita. Thus, fast-growing countries like China, India, Indonesia, and Thailand have unusually high levels of sophistication for countries at a similar income level. Conversely, Morocco’s exports are less sophisticated and much lower than those of China, Egypt, El Salvador, India, Indonesia, the Philippines, and Thailand. In short, this is another indicator of Morocco’s problem in identifying and developing higher-productivity export activities.

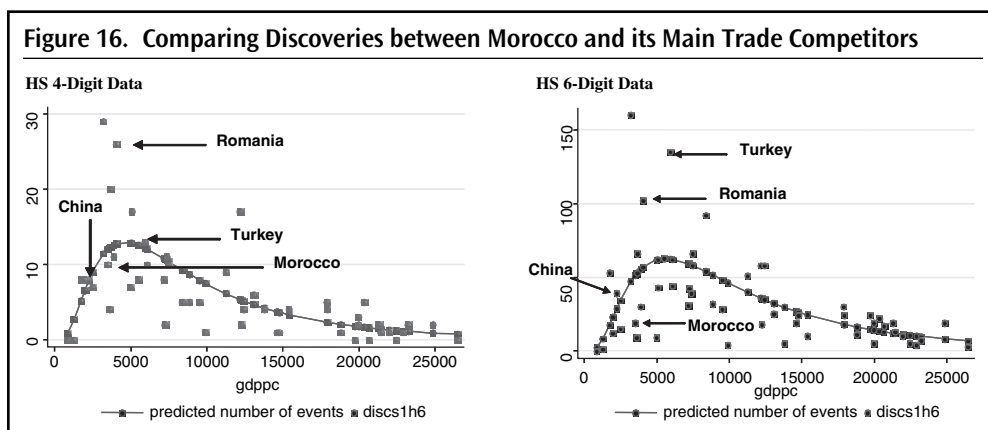
The preceding analysis relates only to the export of goods, not of services. Yet services account for the majority of value added in the Moroccan economy, and these have expanded dramatically over the past decade following privatization and deregulation. While export of services tripled between 1995 and 2004, imports increased at a more modest pace. Net export of services cover no less than half of Morocco’s merchandise trade deficit. Among services, the main drivers of the boom are tourism receipts (which became the main source of foreign currency for the first time in 2005), followed by call centers and other telecom services, and transportation.

More formally, we carried out an innovative procedure that empirically estimates the relationship between self-discovery and growth. We find that Morocco underperforms in discovery activity. In our first step, we find the number of discoveries for Morocco and compare them to its main trade competitors using both Harmonized System (HS)-4 and HS-6 data in absolute terms. To do this, we use the Klinger and Lederman (2004) filter that defines discoveries as exports below US\$10,000 in 1993 and above



Source: WDI.

US\$1 million during 2000–02. According to this filter, Morocco had 19 product lines at the HS-6 digit level during this period. This is relatively low compared with main competitors in China, the EU, and Turkey, or with more dynamic economies such as Indonesia (160), Turkey (135), and Romania (102). These 19 products account for 4.5 percent of 2004 Moroccan exports. Interestingly enough, they are spread across economic activities such as agriculture and manufacture of food, metal, textile, electrical, and chemical products. Our results are robust to the change of filters and years applied (particularly in the end-ceiling point), even though the number and weight of the discovery activities slightly increases when the sample period is expanded (see Volume II, Table II.2). Second, we rank Morocco's discovery performance derived in step one according to its income-per-capita level in a worldwide set of countries. The curves in Figure 16 reflect the inverted U-shaped robust relationship between discovery activity and level of development found by Klinger and Lederman (2004) and based upon seminal work by Imbs and Wacziarg (2003). The curves follow a Poisson distribution. According to such a relationship, discovery activity is low among low-income countries, but rises quickly and reaches a maximum when countries earn between US\$4,200 and \$5,500 per capita. After that point, discovery activity tends to fall. In the case of Morocco, it has a per capita income slightly below the lower threshold, but its position with respect to the curve—both at the HS-4 and HS-6 classification—indicates that its level of discovery should be much higher in light of its level of per capita income. Morocco's performance is also below the level of discoveries found among some of its main trade competitors (China, Romania, and Turkey). Adding this finding to the previous ones provides compelling evidence that low productive diversification and competitiveness is at the roots of the slow structural transformation of the economy, and that the key challenge that faces Morocco's growth is to develop new export products. However, important questions remain about what is ultimately preventing productive diversification to accelerate and competitiveness to enhance. This leads us to the next step.



Source: World Bank staff estimates based on Klinger and Lederman (2004).

Second Step (Part A): Identifying Government Failures that Limit Productive Diversification and Competitiveness

The slow structural transformation into productive diversification is partly the consequence of four government failures. These four government failures combine a rigid labor compact with a high anti-export biased trade regime, thus limiting external competitiveness. First, the labor compact features high labor rigidities. Second, it includes high corporate income tax rates that are significantly above those of competitors in a currently aggressive trend toward reduced taxes in the MENA, Eastern European, and EU regions. It also includes a prohibitive personal tax on human capital in an unusually heavy manner, which discourages enterprises from hiring skilled labor and becoming more productive (see chapter on labor markets below). This way, Morocco does not take full advantage of its substantial past investment in human capital. Third, the combination of labor rigidities with expensive income taxation is compounded by a “fixed” exchange rate regime, which leads to an inflexible policy framework that induces an equilibrium prone to low growth and high unemployment. Finally, the presence of a high anti-export bias not only does not favor export activities, it keeps many sectors of the economy heavily protected and closed to competition.

The Role of Labor Rigidities

Moroccan labor rigidities and costs remain high by international standards. Before the new Labor Code was approved in 2004, Morocco already had one of the highest indexes of rigidity of labor regulations. It is still too early to assess the medium-term ex-post impact of the Labor Code on competitiveness; however, ex ante it has more than doubled previously expensive firing costs (see Volume II, Table V.13). By doubling across the board the amount of severance payments, the “fear from firing” (and hiring) among firms has aggravated. This general finding, however, is tempered by the limited compliance that Moroccan firms acknowledge with respect to the application of the severance payments prescribed by the Labor Code. In the ICA survey, only 16 percent of workers exits because of formal layoffs;

most leave for “other reasons”. In addition, hourly labor costs have increased following a 10 percent increase in the hourly wage from MAD8.78 per hour to MAD9.66 per hour on July 1, 2004.⁶ Overall, the increases to severance payments and to the minimum wage are decisions that reflect a labor compact that has political support, because a high minimum wage reduces salary inequalities and improves living conditions. However, in the absence of similar gains in productivity, these increases are inconsistent with the country’s overall need to promote competitiveness and private investment.

The Role of Expensive Taxation for Businesses

Labor rigidities are compounded by expensive taxation, especially on businesses and human capital. Morocco’s tax structure is biased against productive diversification and competitiveness. Tax modernization and its associated simplification remain top priorities for Morocco. On the modernization front, government authorities recognize the need for reversing the current mix in favor of direct rather than indirect taxation, especially in economies promoting new exports and trade liberalization. Although direct taxes increased from 6.7 to 9.5 percent of nonagricultural GDP between 1995 and 2003, the share of indirect taxes stalled at 12 percent. Customs tariffs’ share decreased from 4.9 to 3.0 percent and is projected to decrease even further with signed free trade arrangements. Shortcomings in indirect taxation—especially in the VAT, which still has very low productivity (0.31 percent of GDP in 2004)—leads to high corporate taxes and a prohibitive general revenue personal income tax (known as IGR). On the competitiveness front, Morocco’s corporate income tax of 35 percent conforms to the current average rates in the region, but is significantly below the regional trends toward lower corporate income taxes in Europe and competitor countries of Eastern Europe. The regional unweighted average corporate rate in Eastern Europe and Central Asia is 20 percent (Le 2006; Pricewaterhouse Coopers 2005). Romania has a low rate of 16 percent. Poland has a rate of 20 percent. Turkey lowered its rate from 30 to 20 percent on January 1, 2006 (coupled with a reduction in its personal income tax to 35 percent). Table 2 reflects the existence of a regional move toward decreased corporate income taxation and other tax holidays in selected Eastern European countries. These countries are actively facilitating competitive edges for private investors, thus upgrading their efforts to attract foreign investment. High tax rates are perceived as the third most important constraint by Moroccan firms in the ICA survey.

High taxes on human capital prevent hiring of qualified professionals. Marginal taxes on individuals are very high and constitute a severe constraint on the use of human capital in Morocco. The country’s personal income tax (IGR) is among the highest in the world, and well above the rate that would correspond to its level of income per capita (see Figure 17). The problem arises from the tax structure. The IGR rises very steeply in the segment of the wage distribution of workers with higher levels of education. It goes up rapidly from a zero percent rate to 35 percent for wages above 36,000 dirhams (about US\$4,000), and to 44 percent for wages above 44,000 dirhams (about US\$4,900), which are the typical monthly salaries of skilled professionals. It is important to notice that in addition to the

6. Monthly wages, however, have remained almost constant, offset by the reduction in the number of weekly working hours from 48 to 44.

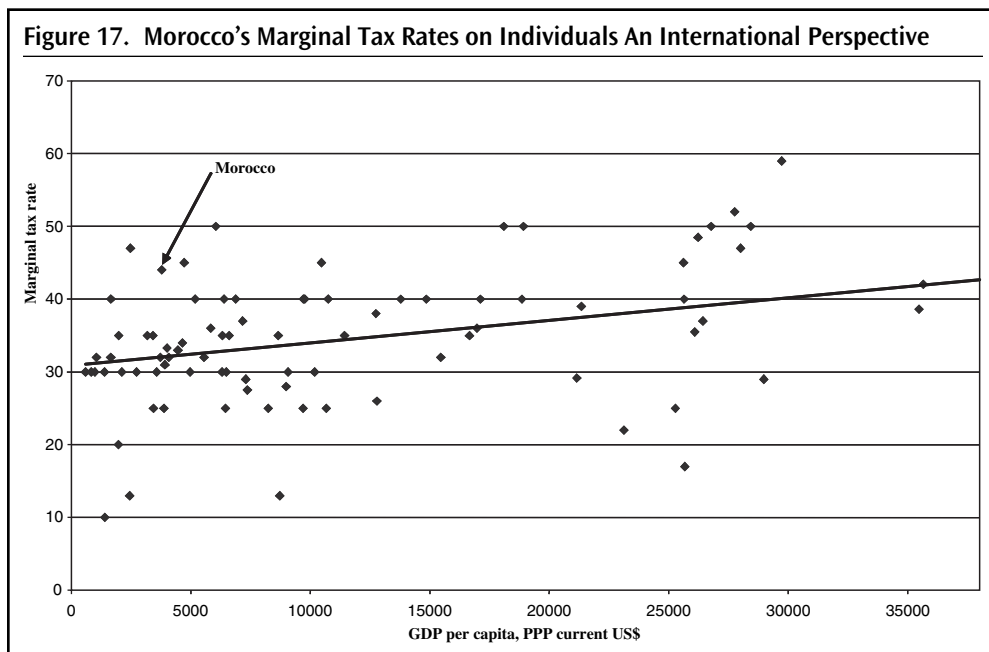
Table 2. Morocco and Some Competitors: Selected Indicators on the Corporate Income Tax Regime

	CIT Rate (%)	Depreciation Method for Equipment	Losses Carry-Forward (C-F, yrs)	Revenues from CIT (% of Non-oil GDP in 2002)	Tax Holiday Conditions
Algeria	30	...	None	1.9	...
Bulgaria	15	...	...	3.0	<i>Production companies:</i> 100% income tax credit for 5 years. Investment in depressed regions: tax credit of 10% of the qualified assets' value during 5 years <i>FDI:</i> 10-year tax credit for projects that meet the conditions by 1998
Czech Rep.	26	Linear up to 20 yrs	5 yrs C-F	4.4	<i>FDI:</i> under certain conditions: <i>Newly established companies:</i> income tax relief for 10 years; <i>Existing enterprises:</i> income tax relief equal to the amount of the increase in their tax liability as compared to the higher tax liability of the previous 2 years
Hungary	17.5	14.5% depreciation rate	Unlimited C-F	2.4	Until 2011, 100% tax credit for <i>investment</i> of more than HUF 100 billion (HUF 3 billion in less developed regions). <i>Development promotion:</i> tax credit up to 14 years for investment of HUF 3 billion or HUF 1 billion for priority municipalities, or HUF 100 million for priority industries, research and creation of jobs
Morocco	35	Linear less a discount coefficient of 1.5, 2 or 3 for amortization periods of 3–4, 5–6, and 6+ yrs	...	3.2	Tax exemption (Corporate-CIT and individual income tax-IGR): <i>Exporting enterprises</i> (including tourism companies established after July 1, 2000): 100% over the first 5 year and 50% thereafter. Tourism companies established before July 1, 2000: 50% of CIT or IGR indefinitely <i>Regions:</i> in specified regions (less developed) 50% tax exemption for the first 5 years (excluding banking, insurance, and established foreign branches). In Tangier city, 50% tax exemption (CIT or IGR and other local taxes that can be cumulated with other exemptions) indefinitely.

FTZ: Tangier port, 100% tax exemption. In Exporting Free Zones established since Jan 2001: 100% CIT exemption for 5 first years, 91.25% over the next 10 years. 100% IGR exemption for 5 years and 80% over the next 10 years.

Poland	19	10–30% depreciation rate	5yrs C-F	1.9	<i>Special Economic Zone: Old regime: significant investment can be granted total exemption for quite a long time for enterprises that received a permit before Jan 1, 2001 New regime: aid in cash grants</i>
Romania	16	...	...	2.0	Qualifying Direct Investment: 20% tax credit of investment made by December 2003. Disadvantages areas: companies with status of “permanent investor” before July 2003 are fully exempted. FTZ: investment over US\$ 1 million before Jan 2002 are exempt up to Dec 2006 for certain operations.
Slovak Rep.	19	Linear, 6yrs	5yrs C-F	2.8	Investment in assets at least SKK 400 million: Special investment incentive regimes up to 100% tax credit for up to 10 years
Slovenia	25	25% depr.rate	5 yrs C-F	1.4	...
Tunisia	35	...	...	2.7	...
Turkey	20	...	...	2.0	Tax incentives are provided differentiated by regions. Investment in certain assets: 40% allowance is tax exempt and may be carried forward indefinitely. Software, research development activities and FTZ companies are tax exempt until December 2008.

Source: Price Waterhouse (2005), IMF, and staff estimates.



Source: WDI.

IGR, there are other indirect charges on labor. Our estimates based on the ICA Survey indicate that at the margin, the amount of payroll taxes paid on the use of professionals by a formal firm represents, on average, about one third of its own profits, or one fifth of its own labor costs. These very unusual high shares depress the demand for skilled workers by the economy and the demand for schooling by households. To the extent that educational skills are complements to technology, this also depresses the technological sophistication of the country, especially in higher value-added activities, thereby encouraging outward migration of higher-skilled workers. A reduction of this distortion would stimulate the demand for human capital by firms, and the demand for higher levels of schooling by households. In addition, it would facilitate the development of activities more intensive in human capital.

A Low-Growth/High-Unemployment-Prone Exchange Rate Regime

Morocco's exchange rate regime can be described as a "fixed" exchange rate regime with a moving band of plus or minus 2 percent around the euro (IMF 2005; Reinhart and Rogoff, 2004). Morocco's currency is officially pegged to a basket of currencies dominated by the euro, but also including the US dollar and other currencies. The weights of the currencies in the basket reflect the pattern of Morocco's trade.

A recent IMF study on Morocco's exchange rate regime reveals mixed arguments in favor of or against modifying the current regime, based on theoretical grounds or historical evidence. Economic integration (especially with France and Spain) and low volatility resulting from terms-of-trade shocks need to be taken into account. The considerations point to a moderate case in favor of continuing a peg. Considerations about financial inte-

gration, the need for flexibility to absorb external shocks, low rationale for fear of floating, and past record of low inflation argue in favor of a floating regime. In terms of outcomes, the evidence is also mixed. This regime has been instrumental not only in reducing the volatility of the dirham, but in achieving low inflation rates, positive current account surpluses, increased foreign investment flows, and external reserves reaching comfortable levels. However, low growth has been accompanied by high unemployment. And although Morocco's worrisome export (and trade balance) performance cannot be fully explained by real exchange rate movements, the mild recent depreciation of the dirham has been insufficient to further stimulate exports or reduce imports.

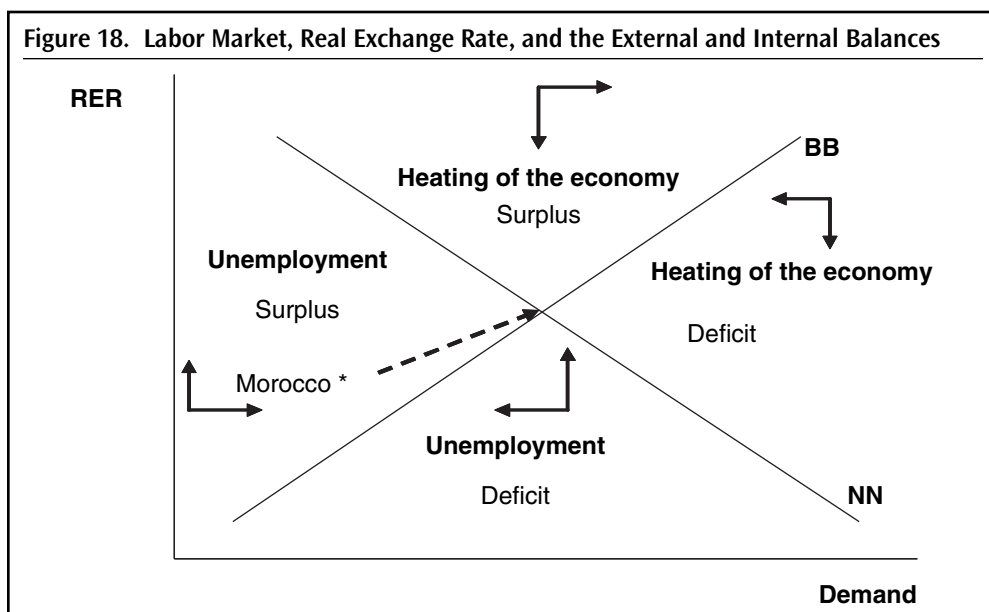
In addition, there is no severe misalignment of the dirham, but competitiveness has been lost compared with US-dollar-based competitors. The appreciation of the dirham in real effective terms since the early 1980s has been mostly reversed with a real depreciation of about 11 percent since 2001, but has not recovered the levels of the early 1990s (see Volume II, Figure II.14). The 5 percent nominal devaluation of the dirham in April 2001, which the Government achieved by increasing the weight of the euro in the basket, has partly recovered losses in competitiveness experienced since the early 1990s. Competitiveness has also benefited from low inflation in Morocco. Hence, the underperformance of Moroccan exports during 2001–04 is not mainly attributable to the exchange rate behavior. However, more recently Morocco's currency appreciated relative to its main competitor in dollar-zone markets: 10 percent from a 2004 increase in hourly minimum wages and no less than 10 percent from the real appreciation of the euro compared with the dollar in 2005 (see Volume II, Figure II.15).

Forward-looking considerations derived from the current and prospective trade and financial policies support a move to a flexible exchange-rate regime. According to the IMF, the present regime poses greater potential for exchange rate misalignments in the future because: (a) increasing trade liberalization and diversification might imply a *depreciation* of the equilibrium real exchange rate, especially in the short run, through deflationary impact on domestic prices; (b) capital account liberalization would make interest-rate differentials (and ensuing volatile capital outflows/inflows) a more significant determinant of the depreciation/appreciation equilibrium real exchange rate; (c) steady higher inflows in workers' remittances and tourism receipts are factors leading to pressure for a real exchange-rate appreciation; and (d) structural reforms, through the Balassa-Samuelson effect that arises from price rises in the nontradable goods sector due to productivity growth in the tradable goods sector, could also lead to a real exchange-rate *appreciation*. These contrasting forces in terms of depreciation/appreciation of the real exchange rate should diminish the volatility in the real exchange rate. This is good news for productive diversification, because high volatility negatively interferes with growth and the speed of the self-discovery process (Hausmann, Rodríguez-Clare, and Rodrik 2005). Because it is not clear which force will dominate, predicting whether a flexible exchange regime would lead to increased appreciation or depreciation of the dirham is very problematic under a passive policy stance.

However, there are compelling reasons to reorient the policy goal(s) of the exchange rate regime toward a real depreciation that triggers competitiveness. On the one hand, some flexibility is required to restore competitiveness and accommodate external shocks, like the market losses faced by textiles in the European market and the terms-of-trade deterioration resulting from booming oil prices. On the other hand, gaining competitiveness through lower salaries is hampered by increased costs and rigidities in the labor market, a back-loaded and perhaps too slow tariff reduction schedule in the economy (which is equivalent

to maintaining pressure for an appreciated real exchange rate), and the prevailing fixed-peg exchange rate regime that sustains an appreciated real-exchange rate for Moroccan exports in US-dollar-based markets. In this context, there is a legitimate question as to whether the exchange rate regime can play a more active role in promoting exports and faster growth.

This dilemma can be illustrated with a little help from a conventional general equilibrium model. Following a simplified version of the model proposed by Dornbush (1980), we combine the demand and supply of the economy to show the combination of income expenditure (E) and relative prices—the real exchange rate (RER)—that will yield, respectively, internal and external balances (Figure 18). RER represents the real exchange rate, or the relationship between relative prices, written as $RER = p_T/p_{NT}$, with p_T representing prices of tradables, and p_{NT} representing prices of nontradables. There are two schedules. Schedule BB represents the external (current account) balance. For instance, to eliminate a current account surplus with unemployment locus, located at “*” on the graph, real spending—and therefore demand for tradable goods—must rise, which justifies the positively sloped BB curve. For its part, schedule NN represents the internal (full employment) labor market equilibrium. Hence, points at the left of BB represent current account surpluses, and points at the right represent current account deficits. For its part, along the NN schedule, there is full-employment equilibrium. Because a reduction in the relative price of tradable goods creates an excess supply, this has to be offset by an increased level of spending to maintain equilibrium in that market, which justifies the negative sloped curve. So, points below the NN curve represent less than full employment (U), and points above represent more than full employment.



Source: World Bank staff elaboration based on Dornbush 1980.

Overall, assuming full and instantaneous wage and price flexibility, full employment and external equilibrium are found at the crossed locus of schedules BB and NN. Both lines reflect a function of the real exchange rate related to income and expenditure. Thus, the Government can choose between policies to adjust the real exchange rate or expenditure. On one hand, an

increase in RER means a real depreciation, and a decrease represents a real appreciation. A rise in the relative prices of tradable goods (real depreciation) reduces their demand due to both income and substitution effects of relative prices, while raising the supply of exportable goods. As a result, a real depreciation favors a current account surplus—a surplus that reflects an excess demand for nontradable goods. However, its effect on nontradable goods is ambiguous, because a substitution effect raises demand for nontradable goods, while the income effect reduces their demand. On the other hand, a rise in spending raises both demands.

With the small current account surplus in 2004 and significant underemployment, Morocco's economy seems to be close to a "low-growth and high-unemployment" point located leftward at "*" . At that level of the real exchange rate, there is slight real appreciation with underemployment. A first possible adjustment, based purely on domestic demand expansion and no change in the level of the real exchange rate, could take place by preserving RER at its level and increasing (public) expenditure in a horizontal movement of the economy to the right (east). Under such movement, the economy would gradually find excess demand for tradable goods (especially imports) and a current account deficit. Correction for a given level of expenditure would require a much higher relative price of tradable goods, eventually requiring a late depreciation of the real exchange rate. A second possible adjustment, then, could be that which is depicted in Figure 18, a northeast movement of the economy, combining an increase of expenditure with a slight real depreciation until equilibrium in both markets is reached. Hence, from the perspective of growth acceleration, a real exchange rate depreciation that increases the competitiveness of export goods would be an important contributor to speedup investment and would create employment.

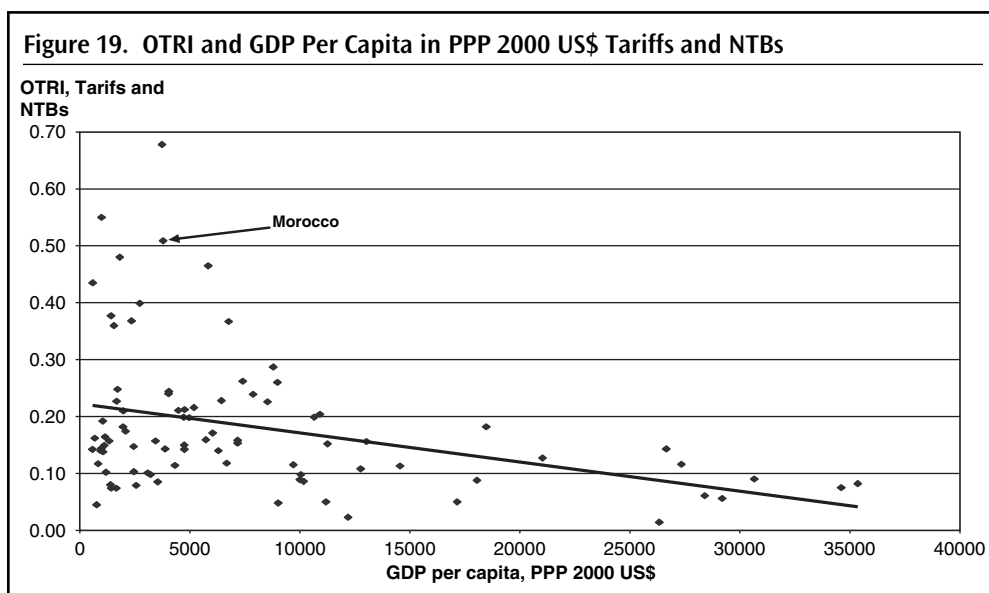
There are other good reasons why favoring a real depreciation of the dirham is convenient for productive diversification. First, Hausmann, Pritchett, and Rodrik (2004) find that growth accelerations tend to occur in periods in which the real exchange rate is significantly more depreciated than in the preceding period. Second, Hausmann and Rodrik (2005) look at the relationship between real exchange rate deviations and growth for a 15-year period (1988–2203), finding that (a) most fast-growing developing economies had very undervalued (depreciated) real exchange rates; (b) the only exceptions are countries with either a strong natural resource dependence (Belize, Botswana, and Uganda) or aid dependence (Mali, Mozambique, and Sudan); and (c) a proxy estimate of such relationship reveals that a 30 percent deviation of the real exchange rate accelerates growth by about 0.5 percentage points. Third, and leaving empirical evidence aside, the greatest returns to discovering high-productivity activities lie among tradable goods and services. This is because such activities can cater to the global market instead of the small domestic market. Hence, the first to produce some tradable good or service in Morocco will not be the first in the world, and hence will be participating in a market where there is already preexisting competition. In this context, a real depreciation, if accompanied by other policy measures, would increase the return to such entrepreneurship and act as a subsidy to self-discovery in tradables, and its impact on aggregate productivity and economic growth might therefore be sizable.

The Role of the Anti-export Bias of the Trade Regime

Morocco's anti-export bias has also preserved a very restrictive trade regime that hindered competitiveness of firms in the development of a truly effective export-led strategy. The World Bank recently compiled an aggregate measure of impediments to imports taking

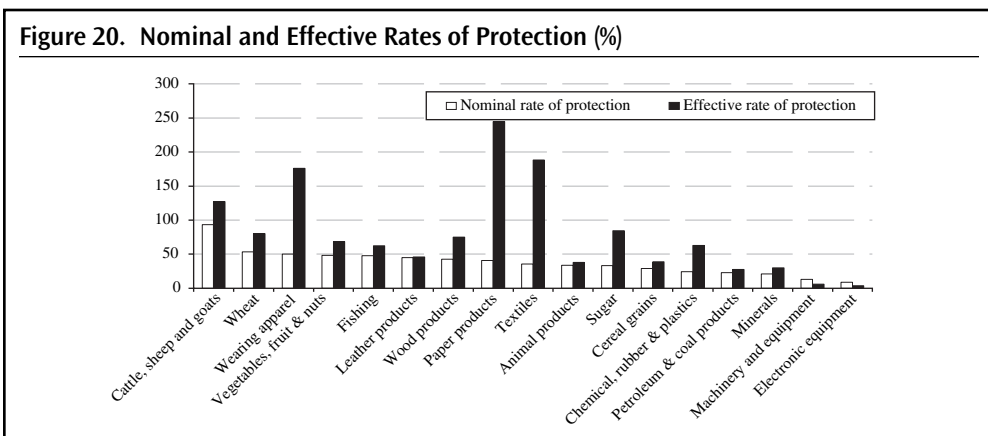
both tariff and nontariff barriers (NTBs) into account (Kee, Nicita, and Olarreaga 2006). This Overall Trade Restrictiveness Index (OTRI) is a conventional measure of the anti-export bias of the trade regime. It is equal to the uniform tariff, which, if imposed at the border, would have the same effect on aggregate imports as the current structure of trade measures. It makes use of updated available data on unilateral, bilateral, and regional preferences and ad valorem equivalents (on average 70 percent of the country's tariff level) of nontariff barriers, and new estimates of import demand elasticities. Results are revealing. During 2003, the value of the OTRI in Morocco amounted to 0.51 percent (Figure 19). The country's index was therefore among the highest among the 92 countries for which comparable data are available. Perhaps more important, Morocco's market is significantly less open than that of comparator countries, such as Tunisia (OTRI = 0.37), China (0.20), Romania (0.16), and Turkey (0.12). It should be added that Morocco's ranking in the OTRI is robust to changes in its content, for the country's position only marginally improves when the OTRI is limited to just tariff barriers, or agricultural tariffs and NTBs, or manufacturing tariffs and NTBs. Such high levels of restrictions no doubt play an important role in preventing competition and self-discovery. However, they are still not conclusive for two reasons. First, the OTRI is based on Most-Favored Nation (MFN) tariffs, which differ from the nominal ones actually applied. Second, by the same token, bilateral tariff reductions that occurred in 2004 and 2005 are not taken into account, particularly with regard to the EU. Moroccan tariffs with the EU are being phased out over a 12 year period. This process—albeit longer than the pace adopted in Eastern European with the EU—has accelerated since 2004, and this is not fully reflected in the OTRI. Hence, a complementary indicator is needed.

The anti-export bias is perhaps better encapsulated in the concept of effective rates of protection (ERP), which also confirms the presence of high import barriers in Morocco.



Source: World Bank and Hiau Looi Kee and others (2005).

ERPs take into account tariff protection to inputs and outputs. They differ from nominal tariffs that are only applied to the final outputs. Nominal tariffs often wrongly suggest that protection is lower than it really is. For instance, taking into account recent tariff reductions granted to the EU countries, Morocco's import weighted average tariff declined from 22.1 percent in 2000 to 18.8 percent in 2004.⁷ But this is only a partial view of the level of protection. Local producers also benefit from inputs, raw materials, and capital assets with lower tariffs than those set for final products. This benefit to local producers is known as "tariff escalation", that is, a tariff-equivalent differential that adds up to the nominal tariffs insofar as it is not received by foreign firms. In 2005, ERPs exceeded nominal rates of protection in most sectors. Paper, textiles, clothing, and food products had the highest tariff escalation (Figure 20). In the future, ERPs might reasonably be expected to decrease gradually to the same extent as import-weighted average tariffs.



Source: World Bank staff estimates.

Second Step (Part B): Identifying Market Failures that Limit Productive Diversification

The slow structural transformation into productive diversification is partly the consequence of market failures. This requires a case-by-case analysis. Romer (1986) was the first to emphasize the role of externalities in the accumulation of knowledge, and Romer (1990) introduced innovations as a proximate source of total factor productivity growth. Following Arrow (1962), he forcefully argues not only that such externalities exist but that they are a major source of economic growth. This includes three negative externalities, in particular: information, coordination, and learning externalities. Negative information externalities arise

7. Customs authorities have different broad estimates of 2005 import weighted tariffs, averaging 13.8 percent for agricultural products and 7.4 percent for manufactured products. However, these figures are biased downward because they include zero-rate exempted imports for Free Trade Zones and re-exported products, which never enter the domestic market.

from rapid profits socialization, especially when property rights are not respected, which act as a disincentive for new entrepreneurs to invest in new activities. Poor coordination externalities arise from the lack of critical inputs or an inefficient mix of inputs in the development of new projects. These failures often point out to the government's side—for example, with the provision of public goods such as infrastructure, quality and specialized education, and efficient procurement procedures. Learning externalities arise from perceived deficiencies in human capital. Extremely low levels of specialized training found among Moroccan firms (see Volume II, Figure III.14) are a handicap to their competitiveness.

An important clarification is that the presence of those externalities, though easy to understand in theory, is very difficult to measure empirically. There are several reasons. First, there are no user-friendly indicators available on new-firm activities. Second, measuring the degree of presence of an externality in different markets—domestic or external—characterized by different conditions and technology, requires product-specific analyses that are rarely found in Morocco. Third, each self-discovery product is often affected by at least one externality, though not necessarily by all three. Hence, the nonquantitative nature of the information available for reviewing externalities does not allow us to measure—only to infer their degree of significance, that is, which one is more important than the other. Their relative importance may actually vary considerably from one activity to the other. Thus, we must rely on the strong theoretical basis that serves to identify their critical role in each activity.

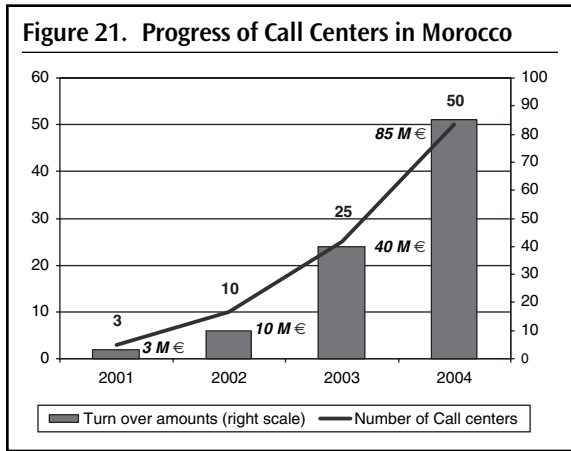
These shortcomings all point to the need for a case by case diagnostic. Three case studies are developed below. These are chosen from the wider set of Moroccan product discoveries and based on interviews in situ during field visits to Casablanca, Tangier, and Rabat. Although not all findings are supported by quantitative evidence, the rationale behind each case is so compelling that it strongly suggests that these externalities also are, indeed, binding constraints to productive diversification (and growth) in Morocco.

The Role of Information Externalities

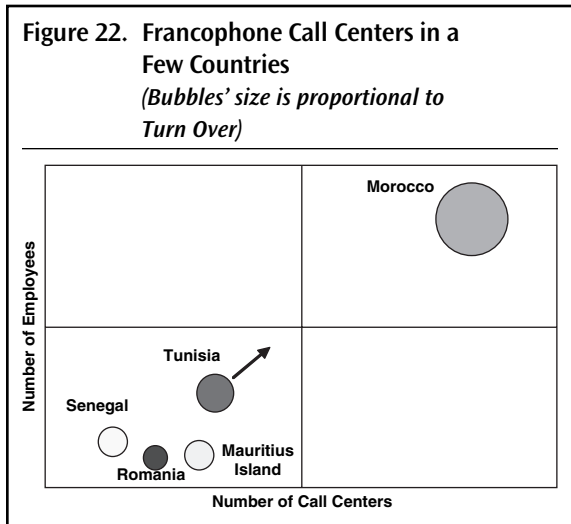
Information externalities arise from the fact that it is easier to copy or imitate than it is to create. This externality means that part (or even most) of the returns to innovation in a new product are likely to spill over to other firms. By reducing the expected private return to innovation, these externalities bring disincentives to create. Thus, low expected returns to innovation keep self-discovery efforts low and, hence, affect growth. In response, the world has opted to consider the outputs of innovators as an items of property needing protection, hence patents, copyrights, and other forms of intellectual property protection. These grant monopoly power over an idea to its creator. New activities and products—whether exported or domestic—may require specific public capital that nurtures and protects them until they reach some level of production, or changes are made to rules and regulations that were designed in ignorance of their negative consequences.

Perhaps the best-known case of Moroccan firms facing information externalities is the call centers. Introduced in 1999 by a Moroccan entrepreneur competing with similar businesses in Senegal and Tunisia, Morocco has become the main African service provider in French and other languages (Spanish, Italian, German, Dutch, and English). Morocco now hosts many top international firms—Transcom (Swedish, number two worldwide), Phone

Assistance, CBI, CRM value, Outsourcing, Accolade, Sitel, Karim Bernoussi (ex-Microsoft), Hassan Mansouri (Primarius), and others. Indeed, many French companies have decided to close their call centers in Europe and establish themselves in Morocco. Call centers targeted a market that was rapidly expanding—the provision of interactive information and marketing services to French telecom companies. The first of those was Webhelp in Paris. With little state help other than exemption from value-added tax on its export of services, these businesses mushroomed. Between 2001 and 2004, the number of call centers grew from 3 to 50, with an estimated annual turnover rate of US\$85 million (Figures 21 and 22). In 2005, there were an estimated 70 to 100 call centers in Morocco. They have reportedly created more than 60 formal businesses and 7,500 employment positions—including a large majority of women working as operators—and their annual net profits rose from zero to an estimated US\$100 million. Two main advantages work in Morocco’s favor—first, the rapid expansion of this market worldwide (despite tough competition from India, Philippines, Mexico, Tunisia and Senegal) and, second, its hub status in telecom services for the rest of Africa.



Source: CSC Peat Marwick/Capital Consulting-ANRT 2004.



Despite this rapid success, Morocco faces serious information (and other) externalities:

- *As businesses expand, profits per firm have declined and global returns have socialized.* This is the outcome of their low initial requirements in factors of production—little training and relatively small fixed-capital requirements. The first company that found that Morocco could produce and export call center services to France (and then to Spain) earned enormous profits. However, these gains were then shared with dozens of new companies that were subsequently set up. In sequence, follower companies gained know-how by raiding managers and operators from the first companies that were created.

- *Information externalities go beyond Morocco.* Companies like Transcom have created subsidiaries in Tunisia to reportedly specialize in Italian services, thus splitting previous profits realized in Morocco.
- *Significant learning externalities are also apparent and further contribute to reduced profits.* On the one hand, Moroccan managers are often approached by foreign companies in regard to their availability to move to other countries. As a matter of fact, wages offered by Moroccan call centers are higher than those in Tunisia and Senegal. On the other hand, call centers are encountering difficulties in reducing rapid turnover of their labor force. Call center operators, indeed, require little previous education and in-service training in general. They need more specifics on the French language as spoken in France, as well as training in basic telecommunications, information technology, and communications skills geared toward client needs. Several reasons explain the rapid turnover: (a) small salary increases in a market featuring fixed remunerations; (b) young and scarcely specialized labor supply; (c) low prospects for internal upstream labor mobility in a business characterized by a very simple organizational structure; (d) high levels of stress in a business requiring high productivity; (e) grueling work schedules because many call centers work 24/7 hours; and (f) monotony related to limited work positions (incoming calls, outgoing calls, administrative staff, and suppliers). Rapid turnover has contributed to a generalized wage increase among operators.
- *Many coordination externalities could be addressed with government intervention.* For example: (a) local governments could invest in attracting call centers to de-localize their installation; (b) improving language skills in French and other foreign languages, as well as in information technology services could be advanced in the formal education system and in vocational training; (c) some ISO standards could be enforced to upgrade the quality of their services; and (d) new fiscal and financial incentives might be considered under the incoming strategy for E-Maroc.

Thus, coordination externalities also bring a rationale for government intervention. Imagine, for example, an investor who knows from feasibility studies that dried tomatoes can be produced cheaply in Morocco. Consider the obstacles this investor would face in exporting to Europe or the United States. Help would be needed with transport, logistics, customs, phytosanitary standards, marketing, and distribution. The investor is unlikely to possess the expertise or the scale for downstream investments in these areas that would make this work. The available options are unattractive—dealing with third-party brokers, expensive transport networks, ineffective marketing, and so forth. How different things would look if there were a large number of Moroccan tomato exporters that all needed the same services. Then the scale effects would come into play, and the downstream services could be organized much more efficiently—either with the exporters banding together or with the creation of an independent company that services all exporters. Such complementarities among lumpy investment projects are a common feature of nontraditional activities.

Morocco offers important lessons on successful handling of coordination externalities based on its experience with tourism. In 1995, Morocco received about 2.5 million tourists. Their receipts represented about 4 percent of GDP. By 2005, these numbers had more than doubled, which would certainly qualify tourism as a “product” discovery. But this did not come about by accident. A new national strategy was laid out in *Accord Cadre: Vision 2010*

in January 2001, making the tourism sector a national priority. The goal is to reach 10 million tourists within a decade. The strategy is based on attracting tourism wholesalers with a supply-driven enhanced lodging capacity. This involves tripling hotel capacity, constructing 80,000 new rooms, and renovating 30,000 existing ones. If successful, some 600,000 new direct and indirect jobs would be generated. Complementary investments are developing in site-specific and off-site infrastructure; flexible financing; enhanced human capacity; adequate air, land, and sea transportation; and successful training of some 72,000 personnel. These actions would cost some US\$9 billion. The commitment of private and public parties to undertake the needed measures is spelled out in an implementation agreement signed by both parties and revised annually under the presence of His Majesty the King. The resulting progress has been notable.

- *Six coastal tourism sites have been identified, five of whom have already been awarded to well-known international investor-developers.* One site has already started to market equipped spots and facilities, and the others are expected to do so by the end of 2006–07. Overall, more than 22,000 new hotel rooms have been added since 2001, with an average growth rate of 8 percent per year. While this number is less than the 80,000 new rooms that were targeted, the rapid ongoing construction efforts should rapidly fill the gap by 2007–08.
- *Air transportation has been liberalized.* An Open Sky policy has been adopted. This has enlarged tourist transportation capacity, reduced the costs, and expanded the choices in traveling to Morocco. Subsequently, many tour operators can now charter air companies between selected European cities and the principal tourist destinations. Currently, more than 12 air companies have been awarded the right to freely transport customers to Morocco. A National Company (Atlas Blue) has also been created to handle low-cost transport between major tourist cities in Morocco and principal European cities.
- *Tourist arrivals and receipts have achieved important dynamism, despite important internal and external shocks.* The 9/11 attack, the Casablanca and Madrid terrorist attacks, and the Iraq War negatively affected world tourism activities but had little impact on tourism flows in Morocco. Tourist arrivals have increased steadily since 1998 by an average of 7.4 percent per year. Arrivals reached an unprecedented 5.3 million in 2004, of whom 2.7 million were foreign tourists. Corresponding receipts increased even faster—an average of 14.3 percent per year, generating almost US\$4 billion (9 percent of GDP) in 2004. In 2005, tourism receipts represented the largest single source of foreign exchange, slightly above that of workers' remittances. Morocco's tourism contributions to GDP and total employment remain below those of comparator countries (Greece, Portugal, and Tunisia); but if present trends are maintained, Morocco will narrow that gap in the next years.

The Role of Learning Externalities

Learning externalities also constrain private investment. Imagine an investor who is considering the establishment of a business. This probably implies finding good workers who do not necessarily live nearby. The investor understands the obstacles that will be faced in finding the proper skill mix and experience among the prospective workers. If the business

is not located in a main urban center, help may be needed in attracting skilled workers willing to move away from the larger cities. If good workers are found, the demands of new technology may require basic training in a country whose in-service training ranks, according to the ICA survey, among the lowest in the world (World Bank 2005c). And even if this investor luckily and skillfully surmounts all these obstacles, there is still the problem of retention of workers once they have been trained, which is a main problem among new businesses as illustrated by the experience with call centers. Finally, a foreign investor is unlikely to have expertise to deal with all those problems alone, so additional costs may be necessary for local advice. How different things would look if there were other firms in the same situation. Then the scale effect would also come into play. Overall, failures in solving such learning needs deter private (and especially foreign) investors, particularly if they see too many obstacles to finding an adequate, quick-learning labor force.

The Free Trade Zone (FTZ) in Tangier provides a good example of a geographic area with firms developing new products and activities, having successfully dealt with learning and other externalities. The FTZ has been in operation only since 2001. It has grown mostly based on foreign capital (80 percent of the nearly 130 firms), which have been attracted by fiscal, infrastructure, and geographic incentives. When compared with other FTZs in the region and worldwide between 2001 and 2005, the FTZ achieved impressive outcomes. Employment rose from less than 6,000 to almost 18,000 positions. Exports more than doubled, from less than US\$90 million to more than US\$200 million. All available slots from the first construction phase have been sold. Today, the zone is crowded by a well diversified set of foreign firms from France, Germany, Italy, Japan, Portugal, Spain, and the United States. They are engaged in more than 100 export-integrated activities—textiles and leather, electric parts (car cables for Volkswagen), electronic components (Phillips), mechanical parts (Airbus parts), fish industry (*décorticage de crevettes*), chemical products (paramedical equipment), textiles, *gilets pare-balles*, plastic products (Polydesign), and offshore services (call centers, information technology, international businesses). Manufacturing is far from the only economic activity of the FTZ, for services are also developing fast. It is hard to point to a single explanation for such dynamism, but obviously, externalities have somehow been well addressed.

- *The FTZ itself is a good example of dealing with government failures.* Tax, tariffs, customs, infrastructure, and free exchange convertibility provided to industries helped attract labor-intensive assembly operations as a unique investment opportunity for domestic and foreign investors. FTZ operations are exempt from import duties on capital equipment and inputs. They do not pay corporate income and value-added taxes, municipal taxes, or the tax on transfer of real property so long as their output is destined for export markets. Five foreign banks have been established under a special regime that exceptionally allows full convertibility in place. No workers' unions exist in the Zone, yet the labor code is strictly enforced. Infrastructure expansion plans are also ambitious; the airport is located nearby; and there will soon be rapid access to another FTZ to be established in the new port of Tangier (the Tangier MED project), which is on track for completion by 2007. Conceived as a future container hub, this port is not only supposed to absorb at least 40 percent of the actual maritime trade to Casablanca, but is expected to reduce the exceptionally high transportation costs by at least

- half (at present, ships traveling from Casablanca to Tunisian ports first need to go to Antwerp, Belgium!).
- *However, among major problems, learning externalities remain critical.* Especially for skilled workers, labor supply remains scarce. Firms (a) pay a 20 percent average premium wage to mobilize workers to Tangier; (b) provide continuous training in situ; (c) continuously scout for skilled and non-skilled workers in other cities; and (d) would welcome the opening of vocational careers at the universities in Tangier (a problem that could easily be addressed with public intervention).
 - *The FTZ also provides good examples of how information externalities can be solved.* The case of a Volkswagen firm producing cable parts for its main subsidiaries in Europe is revealing. This was among the first firms to be established in the zone. During its first year, the firm suffered severe labor problems in attempting to impose a German managerial style. Not only did this attempt fail, it was traumatic. Severe losses forced the firm to fully replace its local management. Having learned from this experience, the firm has adapted its managerial style to the Moroccan labor environment; and it is now performing well. There is no doubt, however, that other cable (and other FTZ firms as well) have benefited from the socialization of this information externality, preventing similar losses elsewhere.
 - *The FTZ would benefit from solving a few pending failures arising from coordination externalities.* There are several examples: (a) Improving maritime transit in Tangier—which worsens during the summer when transit of merchandise stops to give priority to the transport of passengers—and which raises firms transportation costs as they have to pay air shipment to comply with their committed delivery schedule. (b) Increasing container storage facilities in the incoming Tangier-Med port, which promises to become a major international hub, thus serving not only Moroccan firms but users from other countries, and that will allow Moroccan firms to take advantage not only of fixed-location effects and reduced transportation costs but of agglomeration facilities. (c) Developing a public transportation service between the zone and the workers' housing facilities. (d) Promoting large housing projects to host projected increased flows of labor supply needs. Those concerns should be addressed through concerted actions with the Government.

It is hard to predict the full output potential and permanence of the FTZ in the medium term. Through the incoming *Emergence* program (see Box 2 in Chapter 8) Morocco intends to multiply special zones and multiply the number of FTZs as follows: Tangier Port-Med for car and electronics parts, Casablanca for off-shoring services, Nouaceur for aeronautic parts, Agadir and Laayoune for agro-industry and sea food products, and Fez for agro-industrial products. Indeed, export processing zones make a positive contribution to growth and employment if they manage to attract FDI accompanied by technological transfer, knowledge spillovers, and demonstration effects, which act as catalysts for domestic entrepreneurs to engage in new nontraditional exports. However, such attractiveness does not guarantee that FDI flows will follow. International experience with FTZs suggests factors other than local incentives as playing a key roles in decisions of foreign firm to relocate. Regarding incentives, their subsidies should be transparent and justified from an economic and financial standpoint because, in effect, these represent the basis for a new productive diversification policy in Morocco. We return to this discussion below.

How Governance Issues Might Indirectly Relate to Binding Constraints

Governance may indirectly have implications for productive diversification. In a nutshell, what matters is policies that promote rent-seeking. These can be particularly pervasive when they serve to maintain low value-added and noncompetitive activities and waste of public resources. Thus, even if governance indicators are found to be weak or insignificant on empirical grounds, both government and market failures in self discovery may be an indirect consequence of important governance shortcomings.

Empirical evidence to measure the effect of governance on productive diversification tends to be difficult to obtain and, where it exists, mixed. It is hard to assess the direct effects on growth of alternative policies that involve a high degree of discretion in rent-obtained activities, such as tax exemptions, activities favored with special tax regimes, monopolistic practices, or high trade barriers to entry (tariff and nontariff protection). Thus, indirect measures are needed. For example, Figuereido (2005) shows that countries with firms with larger market shares change products less frequently than those with lower market shares, and Morocco is a clear case in which larger firms have control over key sectors like manufacturing (see the following chapter on the ICA survey). So we could expect that discoveries are fewer in countries with dominant larger firms and that exhibit more capture by elite business interests.

However, other literature on monopolistic practices and innovation indicates that both variables are positively correlated, but in a non-monotonic U-shaped curve (Aghion and others 2003). Thus, monopoly is good for early starts because it permits companies to appropriate their innovation efforts; but is bad up to a certain level of degree of monopoly power (and innovation) because it prevents their diffusion and tempts firms to stop innovating and live from their rents only. This produces the nonlinear relationship. A good example is the Republic of Korea, full of *chaebols* with close political ties and strong monopoly powers in the domestic market. Still, however, they were able to expand and become competitive in the global markets. Another example is China's successful and heterodox industrial policy, certainly shaped by protectionist policies, though in competitive and disciplined sectors. Those policies not only encouraged early innovations, but disciplined by retiring transfers to firms that did not comply with their delivery contracts. Thus, in both cases, captured sectors have been relevant for success while receiving significant resources to promote new export activities. Moreover, the sustainability of their success has relied on their ability to identify and phase out declining activities, thus preventing the negative effect from monopolistic practices on impeding the diffusion of innovations.

Despite these limitations, there is an important consensus: all binding constraints identified can be addressed with governance-related solutions. This is as valid for dealing with market externalities as it is with shortcomings arising from the labor compact or the anti-export bias. Public interventions that have the potential to alter the allocation of resources in the economy are always subject to "capture" by well-connected businesses. This is the familiar syndrome of rent-seeking, which has often damaged policies of import substitution and, for that matter, export promotion. Hence, it is important that the institutional setting in which solutions are carried out provide for safeguards against capture, rent-seeking, corruption, and cronyism. Moreover, policymaking needs to be informed by and take advantage of detailed knowledge about market constraints and opportunities that only practitioners in the market can convey. Complete insulation from business interests

is no answer either. A governmental effort to affect structural change must strike a balance between the Scylla of private capture and the Charybdis of bureaucratic ignorance. In response, an appropriate institutional framework for economic transformation needs to strike the right balance between discipline and incentives. With too many incentives, we may end up repeating the excesses of the import substitution in Latin America in which many activities were encouraged far too long despite their questionable social value. Yet with too much discipline, we may prolong the experience of the 1990s in which incentives for economic restructuring were inadequate and insufficient.

How Do Morocco's Obstacles to the Business Environment Affect Productive Diversification?

Perceived obstacles to business development arising from the Investment Climate Assessment (ICAs) survey may slow down investment performance, but they do not necessarily correspond to the binding constraints to growth. Some of these obstacles, however, may explain the lack of private investment in new activities. Based on survey tools, this alternative methodology reveals complementarity to the one developed in the previous chapter. Yet when compared with results from growth diagnostics, the survey findings must be taken with caution for several reasons: (a) They reflect firms' perceptions that may not always conform to reality. (b) Survey responses represent the views of the sector interviewed (in the Moroccan case, manufacturing firms), which is only partly representative of the overall private sector. (c) Findings essentially "hint at" obstacles underlying deeper problems that need further analysis to be fully understood. (d) Survey parametric estimation procedure (compared with the less uniform parametric approach used in growth diagnostic) allows quantitative ranking of the perceived obstacles to business development, as well as comparison of rankings with those from other benchmark countries. Finally, (e) the ICA firms surveyed in the manufacturing sector produces about 18 percent of GDP, but their views do not necessarily match those from other sectors. Thus, not all findings can be generalized to the overall business environment, just to the environment faced by manufacturing firms. Not all the perceived obstacles to business development (and their order of severity) necessarily match the findings from growth diagnostics. While the latter approach is highly selective in its conclusions, ICA surveys care not just about "major" but also "minor" business constraints.

In this CEM, the business environment is examined in the particular case of manufacturing. To do so, an ICA survey was jointly developed by the Ministry of Industry and the World Bank. The ICA surveyed 857 manufacturing industries nationwide. The research

benefited from the fact that about two-thirds of its sample were enterprises already participating in a previous assessment from 2000, which provided stability to the sample of firms selected and allowed testing continuity in the survey's findings. Technical details of the survey can be found in World Bank, 2005c.

At the outset, the mere description of the industrial fabric already reveals a features that point to a sector undergoing very slow change. According to the ICA, Morocco's industrial fabric has the following characteristics. (a) Enterprises are still highly concentrated in and around Casablanca. (b) Manufacturing is largely dominated by the garment, textile, and leather industries. (c) Enterprises are mostly family-run small and medium enterprises (SMEs). (d) Very few enterprises are explicitly engaged in research and development (R&D), but some are involved in product innovation. (e) Over the past few years, some small and medium enterprises (SMEs) have made significant efforts to modernize their equipment: the proportion of medium-size enterprises that have upgraded to automated machinery has risen from 58 percent to 65 percent. However, this is mainly attributable to SMEs.

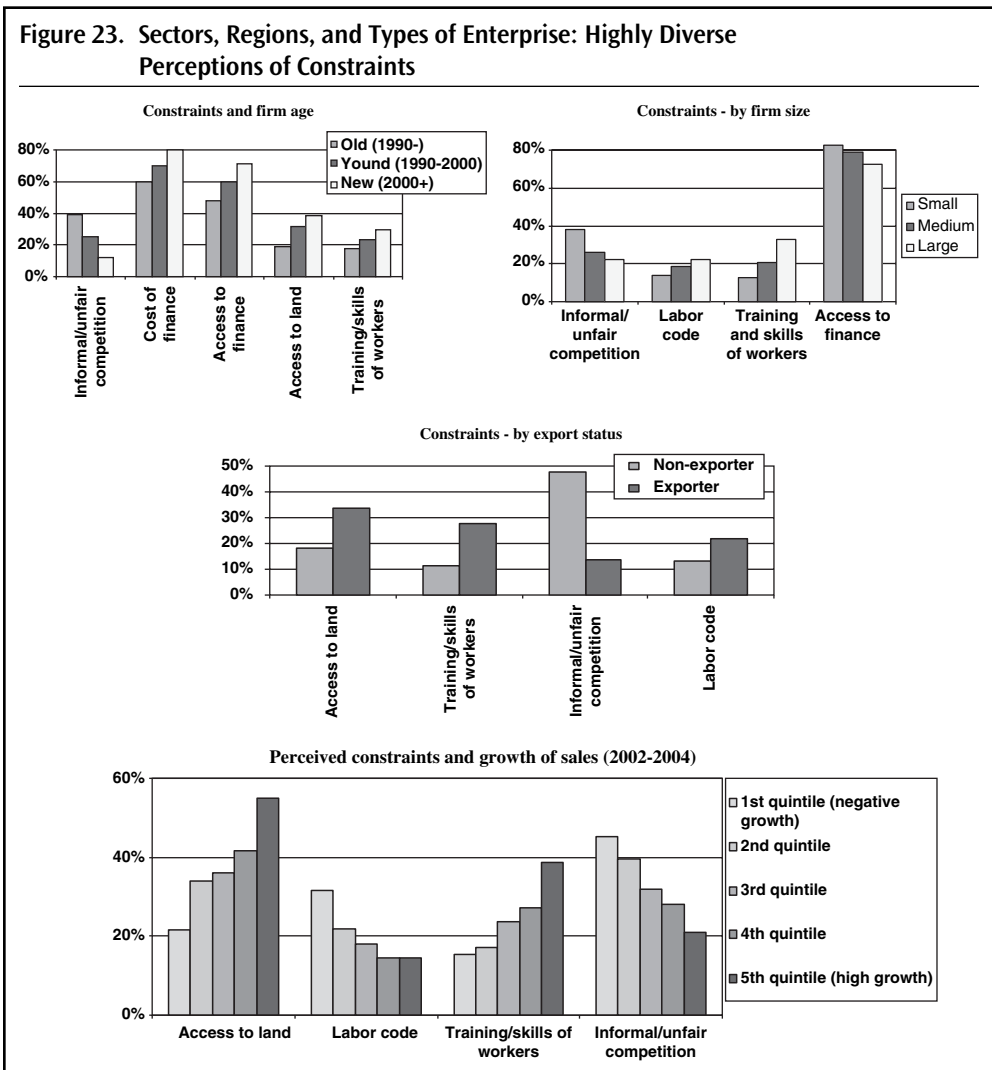
Hence, the speed of the structural transformation of the manufacturing industry still depends to a great extent on the dominance of old, large firms in traditional and declining private sector activities with limited diversification and reluctant entry into new activities. In this context, key constraints in the investment climate may also prevent a rapid transformation, especially if they disproportionately hurt smaller, younger, and less-established new export firms.

In this context, the contribution of the ICA survey to the growth diagnostic approach is twofold. First, it allows a reality check of perceived constraints on the business environment, thus contrasting perceptions from entrepreneurs with hard evidence as shown in the previous chapter. Second, it allows disaggregated review of types of firms' perceptions of the general constraints identified by the survey. This has extraordinary policy implications because it permits discrimination among the obstacles that hurt each type of firm, particularly those that show higher dynamism and different policy recommendations.

The main general findings of the ICA survey show that the Moroccan authorities and economic operators have broadly similar perceptions of their main business obstacles. Some have already been identified:

- High cost and low access to financing. This important concern is not supported by empirical evidence (para.92), the problem is associated to high collateral requirements, poor enforcement of contracts in general, and collateral legislation in particular.
- High level of taxation coupled with uncertainties, difficulties, and arbitrariness in the application of the tax regime. This also relates to the very large informal sector, a factor that contributes to unfair competition, fraud, and corruption.
- Limited access to land and a few severe shortcomings in the trade logistics apparatus.
- Poor competitiveness of enterprises, with marginal budgets for investment research, development, and innovation activities.
- Lack of training of workers, a product of low investment in training by firms. This is exacerbated by inadequate basic education for the working population and low levels of research and development (R&D).
- Institutional (and governance-related) shortcomings are less important in terms of the administration of justice, the enforcement of judicial decisions, corruption, or red tape.

Disaggregating these results allows the ICA findings to show how the Moroccan manufacturing sector is dealing with its own structural transformation. Findings show conflicting views on the degree to which business constraints matter among firms grouped by size, age, type of activity (exporter or not), and degree of dynamism as measured by their sales growth rate (Figure 23). Such views are particularly revealing of the attitude toward structural transformation that different types of firms have. Young and exporting firms often complain about constraints on their growth—access to land, access to good-quality labor, and lack of flexibility in the labor market. For their part, old and nonexporting enterprises mainly complain about preserving their rights facing unfair competition from the informal sector. In the same vein, SMEs report more difficulties in obtaining financing. Large enterprises, however, appear to be more constrained by labor legislation and the low quality of workers. Finally, fast-growing enterprises complain more vigorously about access to

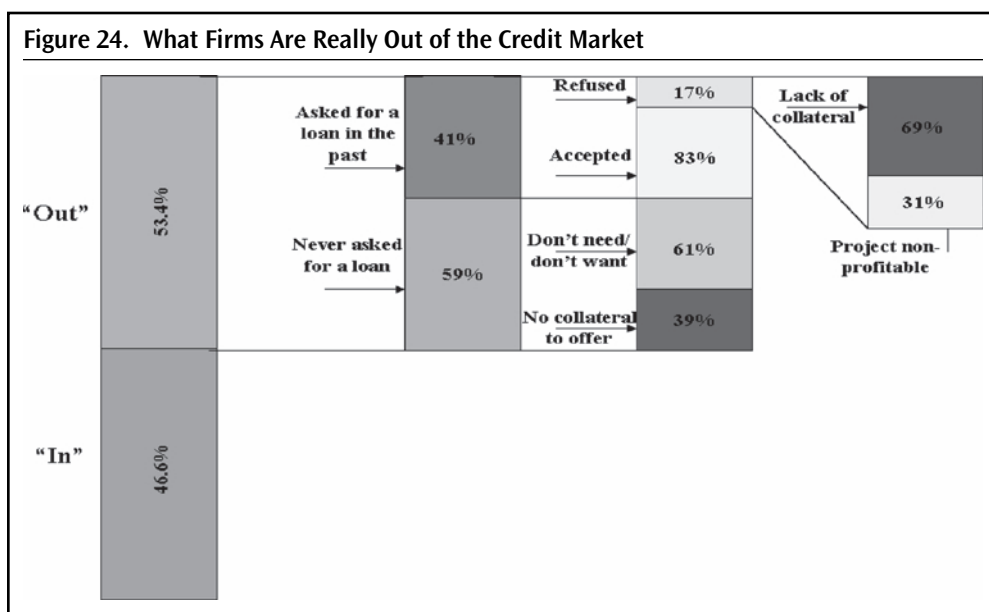


Source: Morocco ICA (2005).

land and skilled labor—essential to their expansion—while enterprises in decline typically complain about an inflexible labor code.

As a result, data suggest the presence of a new generation of Moroccan entrepreneurs that may be part of the engine of future growth. But structural change (particularly in manufacturing growth) is also being slowed by an older generation of enterprises that seem to enjoy a more favorable business climate and are less concerned about expansion needs. Results obviously suggest that to accelerate the growth of the most dynamic and promising Moroccan enterprises, it will be necessary to improve their environment, in part to put them on an equal footing with established enterprises in access to financing.

The ICA survey also allows contrasting perceptions with reality, for instance on financing constraints. While more than 80 percent of firms identify high costs and low access to financing as the two major constraints to the business environment, a disaggregated analysis of the same responses discard such perception. To the contrary, more refined breakdown of responses by enterprises shows that, overall, about 47 percent of firms have loans; about 37 percent have no problem in requesting and accessing loans; and barely 16 percent are out of the system, essentially SMEs (Figure 24). These findings are consistent with the declining interest rates and excess liquidity in the banking system, which support the rejection of financing as a constraint to growth.



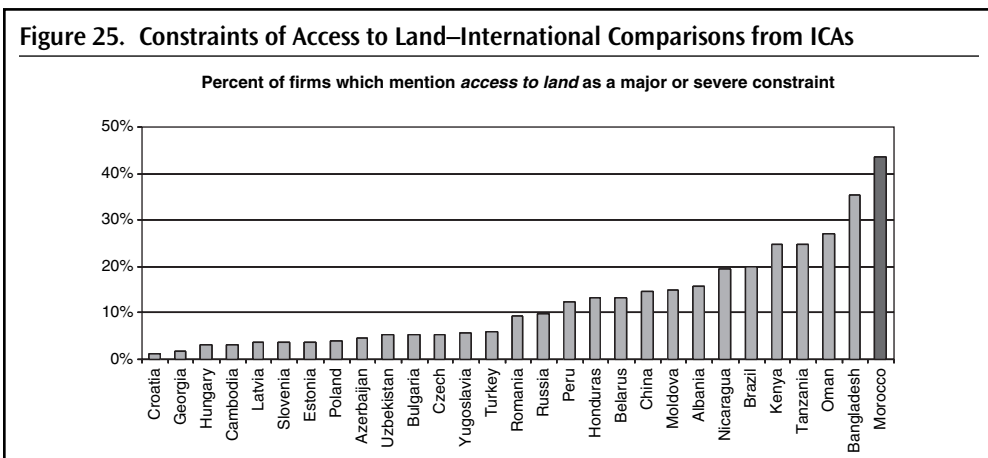
Source: Morocco ICA (2005).

In addition, the survey confirms previous findings on growth diagnostics, though from a different angle. This is the case of government services (including utilities)—a central aspect not only of productivity but of governance—not being a severe constraint to investment. The relatively good performance of Moroccan administrative structures is reflected in an array of indicators resulting from the survey, and comparing them to international benchmarks. For example, the time required to register a business does not exceed five days. Moroccan firms

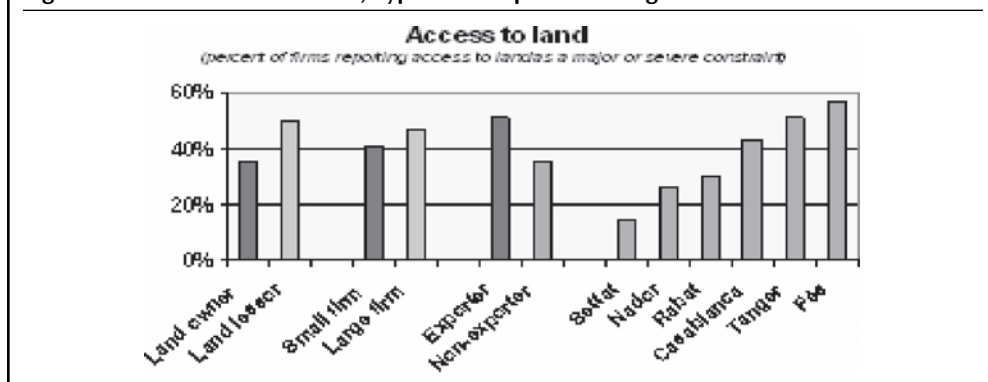
are similarly connected to electrical, telephone, and water-distribution systems within time frames that compare favorably with those of other competitor countries, including China and Poland. In addition, Moroccan entrepreneurs report that had they been obliged to launch their businesses in 1999, they would have needed an average of 10 different permits to commence operations. The number of permits requiring annual renewal is now much smaller—0.5 on average. The number of inspection visits is low compared with other countries. The time required for customs clearance is among the lowest in the developing world.

The ICA survey reveals less critical but still important issues for the business environment, such as access to land. For about 43 percent of Moroccan entrepreneurs, access to an equipped industrial site is difficult and constitutes a major obstacle to the development of their enterprise. The situation is particularly worrisome compared with that of other countries. Among the 35 countries covered by an ICA survey, Morocco has the highest level of dissatisfaction (Figure 25). This might be considered just a perception; however, data disaggregation shows that the intensity of such a constraint mainly affects large and exporting firm expansion. As such, it merits attention. Access depends to a great extent on the region where the enterprise is located, the size of the enterprise, whether or not it is an exporter, and its degree of dynamism. Surprisingly, the problem is even more acute in the key productive regions of Fez, Tangier, and Casablanca (Figure 26). Enterprises that are renting their sites seem to express the greatest need to purchase a site, probably because the site can then be used as collateral to obtain a bank loan. Finally, large enterprises and exporters seem to be seeking sites, probably in order to carry out their expansion plans and to grow. In addition, this problem is worsened because the demand for land is high in certain areas and the supply inadequate, leading to price inflation. Although the Hassan II Fund offers substantial resources for land and buildings, its eligibility criteria (specific sector) and disbursement procedures (prefinancing at the entrepreneurs' expense) limit its usefulness.

The ICA survey also reveals weaknesses in in-service staff training, too little research and development (R&D), and insufficient ISO certification. Only about 1 out of 5 Moroccan enterprises offers training to its employees, an extremely low ratio by international standards. R&D expenditure enables firms not only to generate new technologies but to



Source: ICAs, several countries

Figure 26. Access to Real Estate, Type of Enterprise and Region

Source: Morocco ICA (2005).

better absorb and adapt existing advanced technologies. This is particularly relevant for countries like Morocco, which do so much low-value added production (*sous traitance*) partly financed by FDI flows. Yet while Thailand and Chinese firms spend an average of 6 and 2 percent of their sales respectively on R&D, Morocco spending on R&D is approximately nil according to the ICA survey, and barely 5 percent of manufacturing firms invest in R&D at all. No published data are available on public sector R&D spending (data on public spending on R&D worldwide are published by UNICEF). In addition, one out of two firms identifies the lack of financing as the main obstacle to R&D, one out of three the lack of highly skilled personnel, and one out of ten the lack of protection of property rights as the second and third most important obstacles for R&D. And barely 5 percent of manufacturing firms produce under a foreign franchise, a very low percentage in international terms. For their part, ISO standards for firms in developing countries are an important source of technological know-how on how to improve their capability to export and compete in global markets. Morocco is among the countries with the lowest percentage of firms to obtain an ISO certification (5 percent), well below competitor countries such as Turkey, China, and Eastern European countries.

Previous findings are consistent with the significant underperformance of Morocco in the knowledge economy worldwide. Moroccan perceived weaknesses in training, R&D, and innovation are consistent with its low ranking in the Knowledge Economy Index (KEI) issued by the World Bank in 2006. This index is built upon four pillars: (a) economic incentives and institutional regime (tariff and NTBs); (b) education and human resources (literacy and secondary and tertiary enrollment); (c) innovation (R&D, patents, and articles published in scientific papers); and (d) information and communication technologies (telephones and computers per 1,000 people and Internet users). On the global KEI, Morocco ranks well below midpoint—85 out of 128 countries (12 out of 19 MENA countries) (Table 3). But as is usual, the main usefulness of these indexes becomes clear when comparing the relative ranking of individual pillars. When compared with MENA and middle-income countries, Morocco's underperformance gap is relatively smaller in innovation and ICT, but more dramatic in education and the level of incentives embedded in the institutional regime. These findings also confirm multiple outcomes, such as the rapid deployment of R&D (especially

Region	Number of Countries	Incentive and Institutional Regime	Innovation	Education	Information Technologies	Global Ranking KEI
World	128	85	70	102	76	85
MENA	17	12	9	15	11	12
Low-Middle Income	38	22	19	37	21	26

Source: World Bank database.

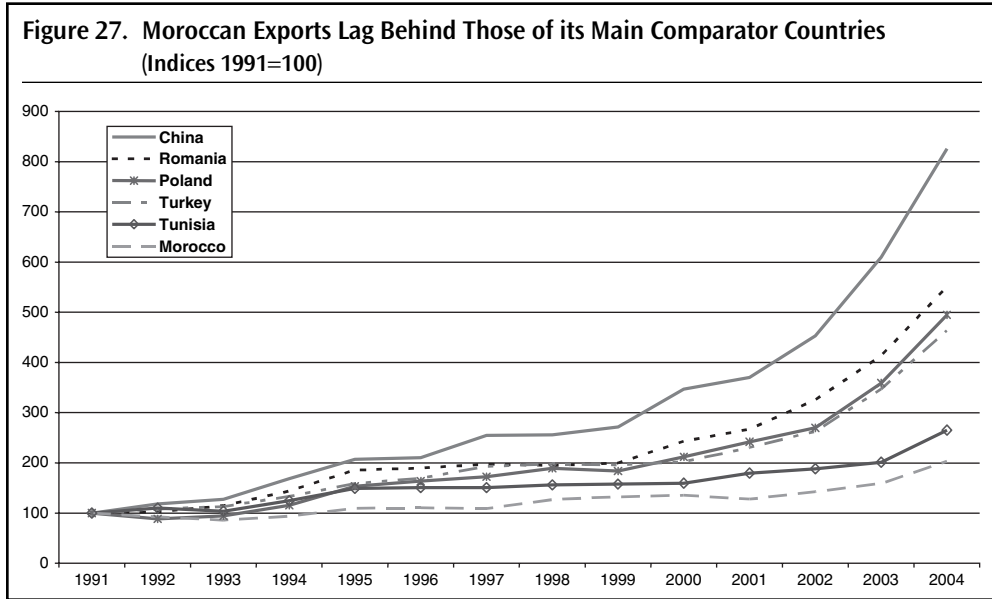
abroad) and telecom facilities in the last few years following privatization; the potential of inadequate education to constrain rapid growth in the future if broader literacy and school quality problems are not quickly resolved; and the need for additional incentives to the innovation environment. Such incentives should recognize not only the high potential of expanding researchers in R&D activities, but the need for strengthened legal protection of (and judicial compliance with) intellectual property rights. New regulations are actually being issued under the follow-up of the signing of the FTA with the United States.

Reducing Anti-Export Bias to Foster Diversification and Export Growth

The idea that Morocco's trade liberalization has a critical role to play in accelerated growth cum productive diversification is beyond dispute. Most of Morocco's main fast-growing competitor countries have relied aggressively on rapid export growth. In the past two decades, China, Poland, Romania, Tunisia, and Turkey—to name just the most important ones—have all experienced rapid and sustained export growth (Figure 27). In so doing, these countries have taken advantage of the opportunities the world market has offered them.

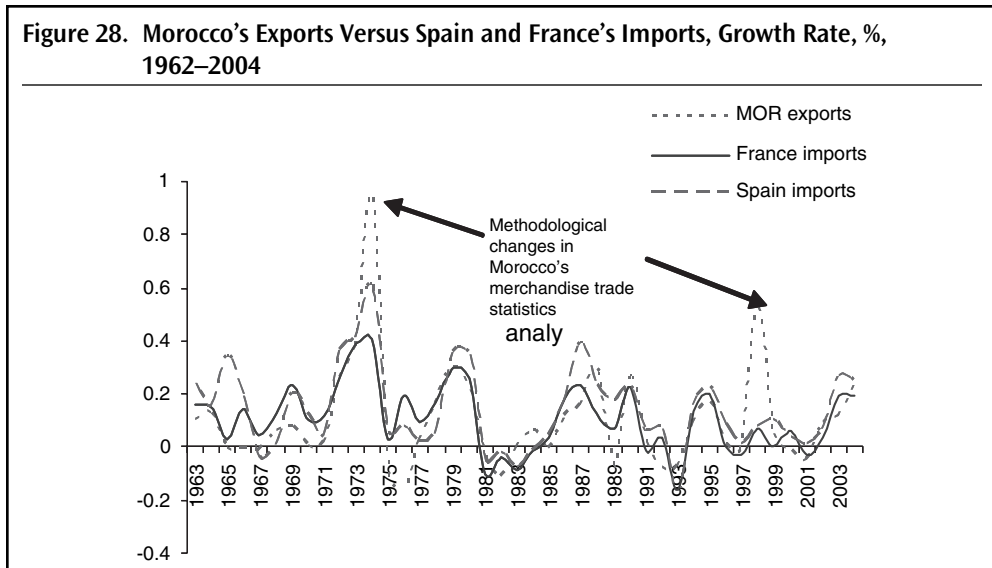
Over the past decade, Morocco's export performance has been lackluster. The country lost world market share in merchandise exports. Declining current account surpluses in recent years have been achieved on the back of strong services exports and migrant remittances. One could argue that weak external demand for Moroccan exports is an important reason. Moreover, the end of the export quotas under the Multi-Fibre Agreement at the beginning of 2005 is exposing textile and clothing exporters to direct competition with low-cost producers in Eastern Europe and East Asia. Yet the explanation is limited because favorable external conditions prevailed over several years of the same years.

Several other reasons explain the relatively weak export performance. Morocco's exports growth remains concentrated in terms of both its supply and its markets, the first reflecting its slow structural transformation and the second its limited market diversification. Exports of garments and textiles, as well as of phosphates, continue to represent more than 50 percent of total exports. Two markets, France and Spain, account for over 50 percent of Morocco's exports. In fact, cointegration analysis confirms the hypothesis of strong structural interrelation between Morocco's exports and Spain's and France's imports. The linear relationship is particularly strong with Spain (Figure 28). Regressing Morocco's exports on France's and Spain's imports (in logarithms) shows that a 1 percent increase in Spain's imports translates into 0.64 percent in Morocco's total exports, and a 1 percent increase in



Source: Office des changes and UNCTAD

France’s imports translates into a 0.43 percent in Morocco’s total exports. From an empirical point of view, one could even argue that Morocco already constitutes an integrated regional market with these two countries. This is a very similar situation to the experience of Mexico before its adhesion to the Free Trade of the Americas (NAFTA) with the United States and Canada. At a minimum, nothing would prevent Morocco from obtaining a special statute from Spain as *Marché Prioritaire*, similar to the one already conceded to Brazil, India, Russia, United States and in January 2006, Algeria.



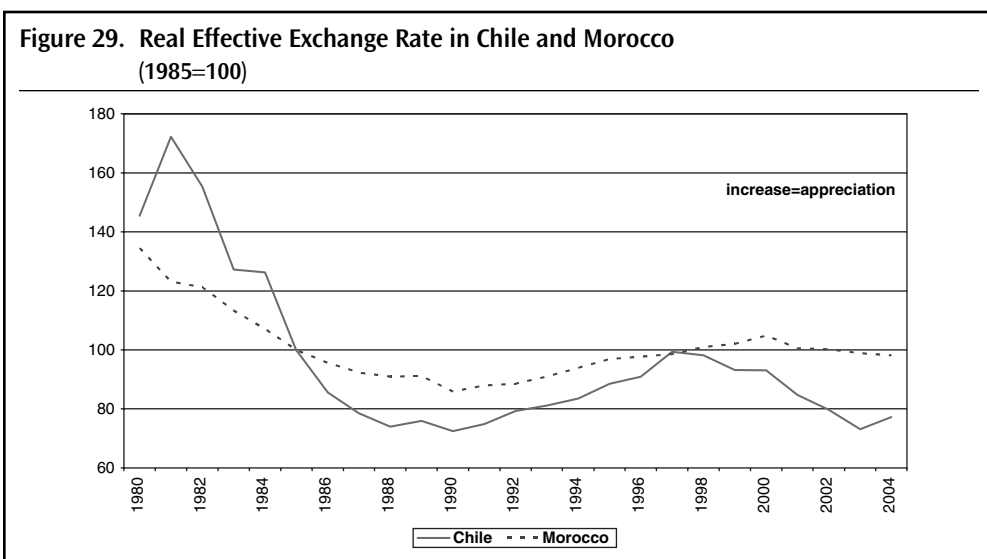
Source: UN COMTRADE and staff calculations.

What else explains the poor export performance (and little diversification) of Morocco? Several indicators suggest that another fundamental reason—the persistence of a significant anti-export bias not removed by trade policies of the past two decades.

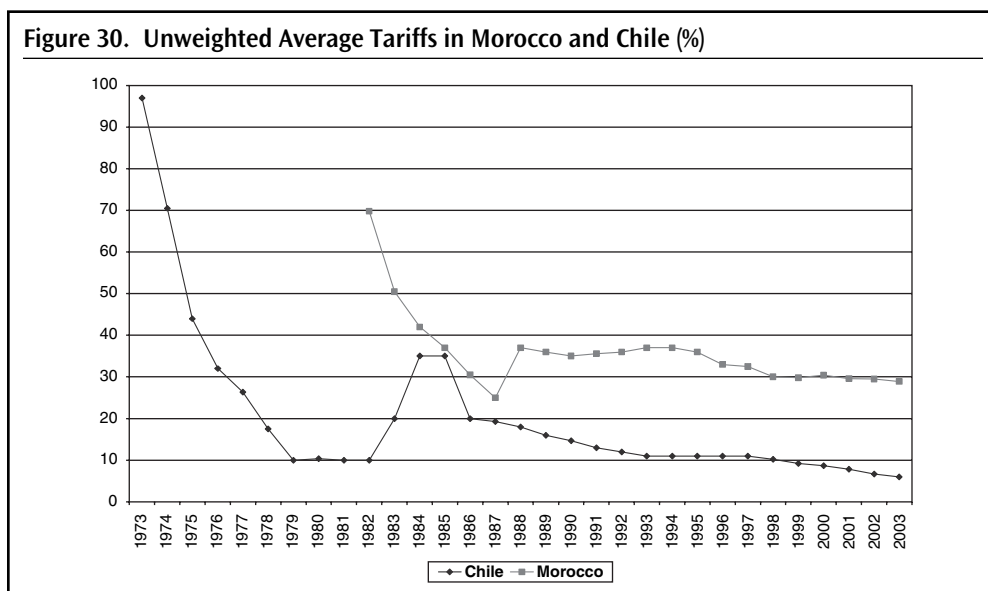
A first indicator comes from trade flow analysis. Trade policies in the past two decades in conjunction with global economic integration have certainly increased Morocco's trade openness. The ratio of exports plus imports to GDP has increased from 48.5 percent in 1990 to 54.7 percent in 2004. But such openness has been import biased. Indeed, imports have been the main driver of such a significant increase, with an average annual growth rate of 6.7 percent during this period. As a result, in the same period, the coverage of imports by exports has fallen from 64.2 percent to 55.3 percent, and in 2005 is expected to have fallen below 50 percent for the first time in more than two decades.

A second indicator is provided by the comparison of Chile's and Morocco's trade liberalization experience. Chile is a natural point of comparison to Morocco. Both are small coastal countries with apparent comparative advantage in agricultural and mineral products. Both countries combined early stabilization and trade liberalization measures in the early 1980s, following balance-of-payment and budget crises. Chile is often cited by Moroccan officials as a model for trade policy reform in Morocco. There are good reasons for this comparison. Both countries had strong similarities in their initial measures of trade liberalization—reduction of tariffs combined with the removal of quantitative restrictions in both industrial and agricultural products and strong real depreciation in the exchange rate during most of the 1980s (Figures 29 and 30).

The comparison shows that Morocco has had a markedly slower pace of trade reform than Chile. First, the tariffs applied to agricultural goods in Morocco remain much higher than those of Chile. In 2002, the modal agricultural tariff for Morocco was 50 percent, while Chile reduced its tariffs to a uniform 11 percent in 1993. This pattern reflects the significant lag of agriculture behind industry in its move toward liberalization. Second, protection in the industrial sector also remains high. The unweighted average tariff for industrial



Source: IMF



Source: WITS-TRAINS

products remains high at about 30 percent. Given signed backloaded FTAs with EU and the United States, plans to reduce it are expected to proceed at a very slow adjustment pace. Third, and perhaps most important, while both countries exhibit the same pattern in the evolution of the real exchange rate (depreciation in the 1980s, appreciation in the 1990s, and depreciation in the 2000s), Chile's record is one of greater and more sustained real depreciation over these periods. Morocco's real depreciations, especially in the 2000s, are rather mild.

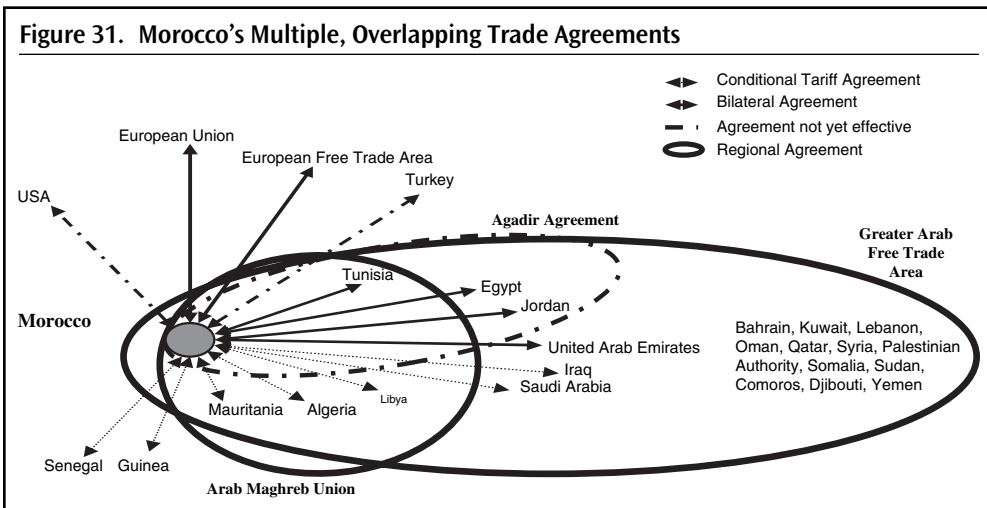
A third indicator comes from direct measures of the anti-export bias. Given the small size of its domestic (and regional) market, and the limited technological capacity of its human and physical capital, Morocco cannot depend only on industrial development and its domestic market to accelerate economic growth. The country's potential for accelerated growth lies rather in the dynamism of its nontraditional (especially higher-value-added) exports because its low-value-added products face fierce competition in their traditional markets. To boost nontraditional exports, the existing bias against exports, especially in non-preferred markets, should continue to be reduced. This bias relies on the restrictive import regime that has generated substantial transfers from consumers to domestic producers and whose high index of restrictiveness OTRI and high ERPs were already assessed above (see Figures 19 and 20). In fact, if firms produce for external markets, they do not receive the same policy-generated support that producers for the domestic market enjoy. Thus, a protective blanket is found in overprotected, rent-seeking, and inefficient sectors with little or no comparative advantage. The effects are manifest through tariffs and (still remaining) non-tariff barriers, prohibitions, technical regulations, multiple rules of origin, safeguard measures, tax exemptions, and public transfers—all to the detriment of the present and potential exporting sector.

Considering the simple average of Most-Favored Nation (MFN) tariffs, Morocco still has significant reductions to achieve in nominal terms. Applied tariffs range from zero to 329 percent; with rates above 50 percent being used only for agricultural products. For

manufactured goods, there are seven non-zero tariff bands (2.5, 10, 17.5, 25, 32.5, 40, and 50 percent), the most frequently encountered rates are 10, 40, and 50 percent. The simple average tariff (2005 data) amounts to 29.5 percent (50.6 percent for agricultural products and 26 percent for manufactures). Tariff dispersion as measured by the standard deviation is high and amounts to 24.2 percent (43.4 percent for agricultural products and 17.3 percent for manufactures). In addition to the import duties, a 0.25 percent parafiscal import tax applies to imported goods.

In this context, bilateral FTAs and market access preferences are expected to help Moroccan exporters defend their position in established markets (EU), enhance their presence in currently underexploited markets (United States), procure intermediate inputs at lower costs than was previously possible (Turkey), and provide incentives to foster innovation and product development. The signing of the Euro-Med Agreement with the EU and its implementation since 2000 represented a decision toward the gradual opening of the domestic market through preferential trade liberalization. This choice has subsequently been reaffirmed through the conclusion of further FTAs with the United States and Turkey in 2004. A detailed account of those agreements and their estimated economic impact can be found in Volume II, Annex IV.A4. Overall, Morocco has signed 11 FTAs and seven conditional tariff agreements (Figure 31). The resulting shift in trade policy paradigms promises to create new opportunities for export-led economic growth and employment generation, while requiring adjustment of domestic producers to the new, more competitive economic environment, and additional policy reforms to complement the market-opening strategy.

However, there are several concerns about both the timing and content that could delay the expected benefits from these agreements. First, Morocco’s tariff phase-out period relative to the EU is much longer (more than twice) than the pace adopted by Eastern European competitors, and it may entail significant trade diversion. Second, multiple rules of origin, mainly with non accumulative rules, may distort trade flows, causing trade diversion and suppression. In this context, the recent agreement with Turkey, which applies



Source: World Bank staff estimates.

Pan-European rules of origin, is a small step in the right direction. Third, technical standards required by European and U.S. markets require further development of local capacity, but are not ready yet and can become a non-tariff barrier. Fourth, and as we saw above, the success in promoting exports goes beyond the mere suppression of trade barriers and mainly relies on what the country exports, as well as the country's capacity to attract and internalize further foreign investment. Fifth, given low trade complementarities with some of the countries with which a trade agreement has been signed, the potential for tangible benefits in the near term can be very small. In other words, export dynamism cannot rely on them exclusively. Besides, estimates of the welfare impact of Morocco's FTAs are in general positive. The edge is in favor of multilateral agreements, but their sizes vary considerably. This conclusion has a possible exception, Algeria. Estimates from a gravity model—relating potential exports and services to the relative size of both countries, their geographical distance, and other country characteristics—indicate that the reopening of Moroccan borders with Algeria would represent a sizable boost for the Moroccan economy of about US\$780 million in exports and another US\$220 million in tourism receipts. In sum, this would translate to an increase equivalent to about 2 percent of GDP.

Perhaps one of the best examples of how competition might positively affect structural transformation is the ongoing diversification of the textiles industry, which is threatened by the end of the MFA. With textiles and clothing accounting for about 17 percent of industrial value added, 34 percent of merchandise exports, and 42 percent of industrial employment, quota abolition is having a major impact on the Moroccan economy. Morocco is, in fact, less exposed to changes in world textile and clothing markets than Tunisia and Turkey, but more exposed than China, Egypt, and Poland.

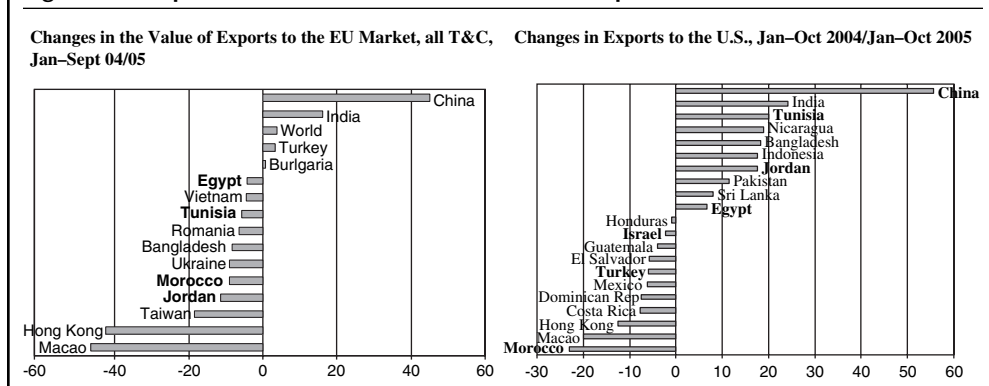
Structural change is no news for the textile and apparel industry, which had to compete in the past decade along other dimensions than labor costs, that is, attributes such as quality, flexibility, and speed of delivery. There is considerable flexibility in both sectors to switch between product categories in response to market signals. Indeed, Morocco's textile and clothing export structure has changed significantly over the past decade. Some categories, such as women's or girls' suits, have experienced a strong expansion in absolute and relative terms; while others, such as men's and boys' overcoats, show a marked contraction (Table 4). However, there remains considerable uncertainty over the future of the sector in the context of more direct competition from eastern and southern Asian exporters since the beginning of 2005. In the first three months of 2005, Morocco's exports of suits and underwear fell in local currency terms by 15 and 21 percent, respectively, compared with the first three months in 2004. Using the Global Trade Analysis Project (GTAP) computable general equilibrium model, World Bank estimates suggest that Morocco will in the longer term experience a reduction in textile and clothing exports, respectively, of 11 and 18 percent, as a result of MFA phase-out. Similarly sized income reductions are projected for other countries in North Africa and the Middle East, while producers in China and consumers in the EU and the United States will be the main beneficiary groups from the liberalization of the world textile and clothing trade.

Any significant export losses in the textile and clothing sector will have important implications not only for Morocco's economy but also for employment, especially among female workers. Morocco's export industries tend to employ a larger share of female employees than import-competing sectors. Indeed, in the highly export-oriented clothing sector, 65 percent of all employees are female, but this percentage can go as high as 93 per-

Table 4. Structural Changes in Morocco's Textile and Clothing Exports, 1995–2004

HS-4	Product Description	Increase in Exports		Share of T&C Exports (%)	
		Current US\$ (000)	%	1995	2004
<i>Ten product lines with the biggest export increases</i>					
6204	Women's or girls suits, ensembles, not knitted	375,018	62	22.9	28.3
6109	T-shirts, singlets, tank tops, knitted or crocheted	189,853	142	5.0	9.3
6212	Bras, girdles, garters, etc., knitted or not	78,472	78	3.8	5.2
6108	Women's or girls slips, PJs, etc., knitted or crocheted	60,248	135	1.7	3.0
6211	Track suits, ski suits, & swimwear, not knitted, etc.	53,266	57	3.5	4.2
6110	Sweaters, pullovers, vests, etc., knitted or crocheted	30,216	15	7.6	6.7
5209	Woven cotton fabrics, not under 85% cot, wt ov 200	25,016	441	0.2	0.9
6106	Women's or girls blouses & shirts, knitted or crocheted	22,085	67	1.2	1.6
6107	Men's or boys' underpants, PJs, etc., knitted or crocheted	18,994	71	1.0	1.3
6207	Men's or boys' undershirts, etc., not knitted or crocheted	14,098	142	0.4	0.7
<i>Ten product lines with the biggest export decreases</i>					
6114	Garments not elsewhere specified or identified, knitted or crocheted	-4,175	-43	0.4	0.2
6210	Garments, of felt, etc., or fabric impregnated	-4,326	-17	1.0	0.6
6209	Babies' garments & accessories, not knitted or crocheted	-4,699	-22	0.8	0.5
5701	Carpets & other floor coverings, knotted	-5,371	-25	0.8	0.5
6101	Men's or boys' overcoats, knitted or crochet	-8,025	-63	0.5	0.1
6103	Men's or boys' suits, ensembles, etc., knitted or crocheted	-11,381	-30	1.4	0.8
6205	Men's or boys' shirts, not knitted or crocheted	-13,876	-8	6.3	4.4
6111	Babies' garments & accessories, knitted or crocheted	-19,417	-52	1.4	0.5
6112	Track suits, ski suits, & swimwear, knitted or crocheted	-19,742	-47	1.6	0.6
6201	Men's or boys' overcoats, cloaks, etc., not knitted, etc.	-21,245	-43	1.9	0.8
All textiles and clothing		819,376	31	100.0	100.0

Source: UN COMTRADE database.

Figure 32. Impact of the MFA Removal on Moroccan Exports to the EU and U.S. Markets

Source: World Bank (2006).

Source: U.S. International Trade Commission (USITC).

cent in SMEs (World Bank, 2006). Hence, any negative changes in export performance and employment scale-downs will more than proportionally affect the female population, with implications for gender balance and the pace of reforms and modernization.

Preliminary information on the effects of the phasing out of MFA quotas is showing, however, that Morocco has suffered only moderate losses in the EU market, thus confirming its adjustment process in the textile sector, but more significant losses in the U.S. market. Figure 32 shows both the changes in EU imports of all textiles and clothing between the first nine months of 2004 and the corresponding months of 2005 (left), and the changes in U.S. imports of all textiles between the 10 months of 2004 and 2005 (right). During this period, Morocco saw a decline of 9.3 percent in the EU market, certainly largest among its MENA partners of Tunisia and Egypt, which witnessed a milder drop of 5.6 percent and 4.2 percent, respectively, but half below the dramatic numbers (above 20 percent) projected in early 2005. Such decline is, however, more significant in the case of the U.S. market. Morocco's drop at 23 percent was largest among large textile exporters to the United States. Such decline contrasts, again, with Tunisia and Egypt, which saw their textile exports increase. It is expected that the application of the FTA with the United States, coupled with renewed dynamism in the European-sponsored *mise a niveau* of firms and recent investment by U.S. firms, like Fruit of the Loom, will allow recovery of Moroccan textile and clothing exports to the U.S.

Labor Rigidities and Employment Creation

Like nearly every country in the MENA region, higher growth is the only way in which Morocco will be able to confront its enormous job-creation challenge. In 2015, there will be nearly 14.3 million workers in the labor force. Morocco's rapidly expanding labor force coexists with an already overwhelming unemployment burden. About 11 percent of the population is unemployed, and high unemployment affects mostly the urban young, educated, and female workers.⁸ Based on a 10 percent expansion of the labor force alone and an average 4 percent real GDP growth, it is estimated that in the next 10 years about 3.3 million jobs will be needed to absorb new entrants and the stock of 1.3 million workers that are already unemployed. This level is equivalent to one-third the current level of employment in Morocco. Dealing with this challenge requires rapid economic growth. Our estimates also indicate that a 6 percent real GDP rate per year—that is, 50 percent greater than the average of 4 percent reached during 2000–04—would reduce the number of unemployed by 1.4 million, close to half (see Volume II, Annex V.A1).

Despite declining population growth rates, demographic transition and rising but volatile female participation have led to positive labor force participation rates (LFPRs). Morocco's population grew an average rate of 2.5 percent between 1960 and 1990 and decreased to a rate of 1.7 percent in the 1990s. Following the last national census, the population growth rate was projected to decline to 1.2 percent by 2005. The dependency ratio—the ratio of the economically dependent (younger than age 14 combined with those age 65 and older) to the working-age population—has steadily fallen from 0.9 to below

8. Throughout this CEM, data on employment and unemployment generally do not vary much by the Ministry of Labor or the International Labor Organization (ILO), nor by date of issue.

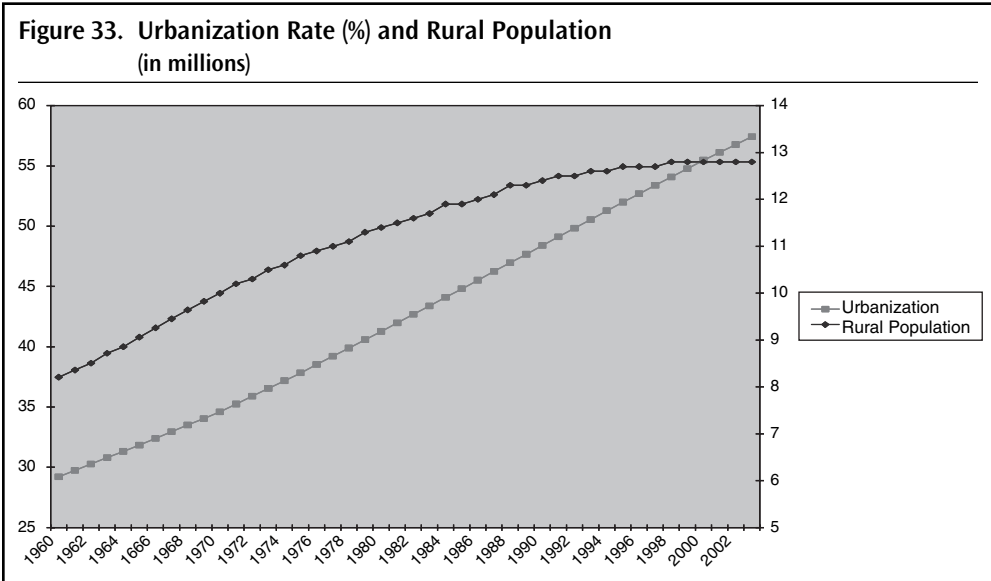
0.6 over the past two decades. Thus, the age structure of the labor force has shifted in favor of the 25-to-44 age cohort to reach 60 percent of the labor force. Morocco's so-called "demographic gift"—the difference between the growth of the economically active population (close to 2.1 percent between 2000 and 2005) and the economically dependent population (about 0.6 percent)—is among the highest in MENA and in the world (World Bank 2004). In theory, such a demographic gift provides Morocco with a good opportunity to accelerate growth through faster accumulation of factors of production, especially labor. In practice, however, insufficient growth and job creation have transformed the demographic gift into a demographic burden. High unemployment rates, especially among youth, and migration abroad, have ensued. Migration outflows have somehow mitigated unemployment pressures and mimic unemployment patterns (see below), but a sizable challenge remains.

Morocco has been moderately successful in decreasing unemployment, which essentially remains an urban phenomenon. In 2005, Morocco's national unemployment rate reached 11 percent, down from 15 percent in 1995. As of 2004, almost 90 percent of the unemployed live in the cities compared with 50 percent 20 years ago. The average education level of the unemployed is higher than for the labor force, signaling the difficulties that the increased number of people with secondary and higher education degrees have in finding jobs. In 2004, the unemployment rate among urban workers with less than basic education was 11 percent, compared with 32 percent among secondary education graduates and 35 percent among university graduates. Similarly, while women with higher education represent less than 10 percent of the total labor force, they were equivalent to about 20 percent of the total number of unemployed. In addition, data from a survey by the Ministry of Labor show that in 2004 the unemployment problem affected primarily the 15-to-24 and the 25-to-34 age groups, which include first-time job seekers and prime-age workers. About half of the unemployed were first-time job seekers.

From the perspective of growth dynamics, it is interesting to look more carefully at these patterns, including declines in fertility, rising schooling, urbanization, and the shift from agriculture toward industry and services. These three processes are not independent. The declines in fertility are usually associated with an increase in the opportunities for women in the labor force because this increases the opportunity cost of having children. By the same token, higher female labor force participation and fewer children mean that education becomes more affordable because there is more household income per child and more taxpayers per student. In addition, urbanization allows for a higher land/labor ratio in rural areas, thus increasing agricultural labor productivity. Higher levels of human capital allow for a greater incorporation of technology and a more sophisticated production pattern. This creates the demand for further increases in human capital.

Combining these dimensions reveals that GDP per worker that has essentially been stagnant over the past 15 years. This occurred in spite of a continued urbanization. This indicates that the problem of growth is not mainly in agriculture, because the share of employment in the sector declined. Rather, the problem is lack of dynamism in urban activities.

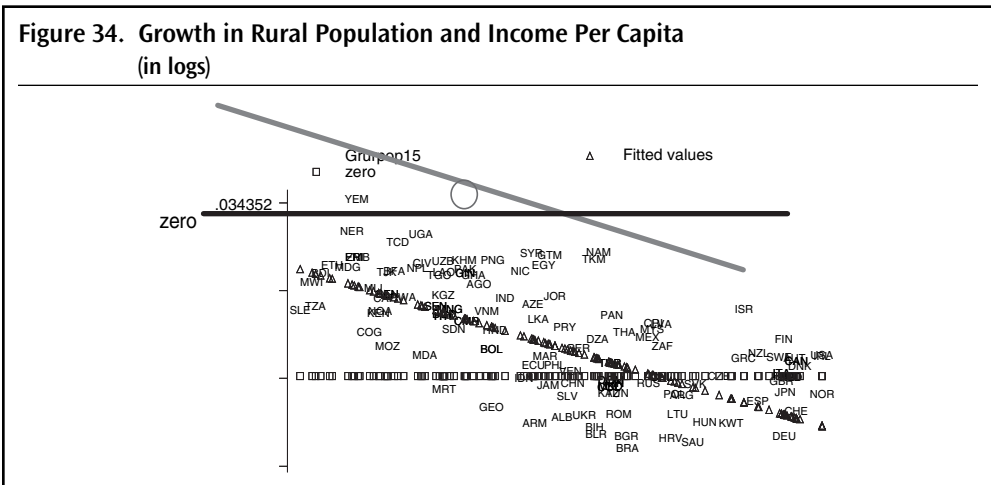
While the population under age 15 has stabilized, the population overall has become more urban. Morocco's urbanization rate increased from 29 percent in 1960 to 57 percent in 2003, a transformation in line with international experience. Morocco's growth rate of urbanization during 1988–2003 was much faster than Egypt, Kazakhstan, and Syria, but slower than El Salvador, Mauritania, the Philippines, and Portugal. This combination of declining population growth and increasing urbanization caused a very significant decline



Source: WDI.

in the rate of growth of the rural population. Figure 33 shows that the absolute number of people living in rural areas has stabilized in the past six years.

The rate of growth of the rural population has an impact on agricultural productivity. As population rises, land-to-labor ratios fall and labor productivity is negatively affected. This creates a headwind that limits the transformation of technological progress into higher output per worker. Conversely, countries with significant declines in rural population have rising agricultural productivity per worker (as well as higher income per capita rates). To illustrate this relationship, Figure 34 presents the rate of growth of the rural population and income per capita (in logs and PPP terms) between 1988 and 2003.



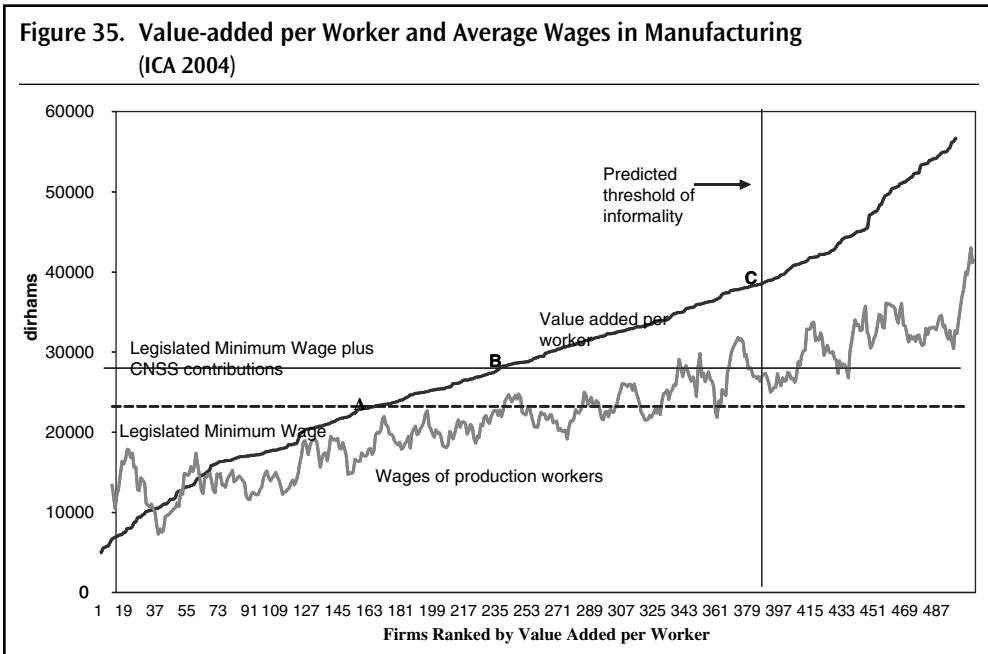
Source: World Bank staff elaboration.

The figure shows that poorer countries tend to suffer from increases in rural population, while richer countries see declines. There are a significant number of developing countries with sizable declines in rural population, such as Albania, Armenia, Belarus, Brazil, Georgia, Portugal, the Republic of Korea, Romania, Saudi Arabia, Ukraine, and Uruguay. First, Morocco falls close to the regression line, meaning that given its rate of rural population growth, its agricultural productivity was normal. Second, the country has a rather small difference in productivity between agriculture and the rest of the economy. The ratio of agricultural to total labor productivity is 1.8, which is low by international standards.

Two conclusions derive from past findings. First, the significant demographic transition accompanied by the urbanization process itself should have led to educational progress (because dependency ratios declined) and, especially, rising GDP per worker (as labor was reallocated from the rural to the urban population). This should have accelerated growth, but “something” prevented urban GDP growth from being stronger. Second, the resulting reallocation of the labor force from rural to urban activities has had a positive effect on overall productivity, although this effect has been smaller than in other countries. As seen above, this is obviously related to the slow structural transformation of urban output that prevents diversification into higher-value-added activities. It is also explained by labor rigidities and high taxation that discourages the use of human capital use by firms. Here is where labor rigidities and the IGR play a key role as binding constraints.

In another reflection of low firm productivity, the ICA survey identifies a significant number of formal firms that are at the threshold of informality because their low productivity and labor regulation costs force them to operate below the minimum wage. Using the survey, it is possible to find the threshold values by combining annual value added per worker and wages for production workers (skilled and unskilled workers) among the manufacturing firms participating in the survey. Using a total sample of 857, Figure 35 ranks the first 500 formal firms from low to high productivity and compares productivity (upper curve) with wages (lower curve). We find three main points.

- *Point A* represents a value added per worker (22,102 dirhams) that is equivalent to the legislated minimum wage. The graph shows that any firm to the left of point A pays wages below the legislated minimum wage, which is the case for approximately 20 percent of the firms in the survey.
- *Point B* represents a value-added per worker (26,995 dirhams), which is equivalent to point A plus labor costs (including social security contributions). At point B, an additional 10 percent of firms in the sample pay wages below their legislated minimum wage and labor costs.
- *Point C* represents the value-added per worker that, on average, is needed by firms to pay the legislated minimum wage and labor costs. To find this, we first estimated the relationship between valued added per worker and wages using ordinary least squares (OLS). We obtained the following regression line: $\text{Wages} = 17,862 + 0.243 (\text{value-added per worker})$ (see Volume II, Chapter V). By reversing this relationship and replacing wages for the legislated minimum wage (26,995 dirhams), it is possible to obtain the floor level of productivity—a value-added per worker of 37,584 dirhams—necessary to pay an unskilled worker a wage equal to the legis-



Source: WB staff elaboration based on ICA Survey.

lated minimum wage and labor costs. This is marked as the “predicted threshold of informality.”

From the above analysis, it is clear that slightly less than half of the formal firms in the ICA survey (390 out of 857) do not reach the floor level of productivity required to pay minimum wages and labor costs in Morocco. The difference between the value added per worker and wages is the estimated profit (before taxes) for a firm. Firms left of point C can be considered to be on the threshold of informality. They face a difficult decision: on average, they are able to generate a maximum profit after taxes (8,364 dirhams) that is about half of the profit they would get by avoiding taxes (15,898 dirhams) (see Volume II, Table V.11). They may conclude that taxes are simply too onerous and thus be tempted to stay informal. In the same vein, a recent report of the Caisse Nationale de Sécurité Sociale (La Vie Echo, February 10, 2006) finds that from the 1.7 million workers declared as wage-earners and employed in 140,000 formal firms, about 700,000 (41 percent) actually receive less than 1,826 dirhams per month of minimum wage. This figure strongly confirms the ICA estimate that 45 percent, or something very close to it, is the actual ratio of informal workers to the total employed.

Low productivity, as well as severe fiscal and labor regulations are major explanations for widespread informal employment. According to official data, the informal sector produces an estimated third of GDP in Morocco (see Volume II, para 5.32). The informal sector is also responsible for about 39 percent of non-agricultural employment (Mejjati Alami 2006). We have discussed formal firms struggle with productivity. Below, we explain the role of labor regulations. For their part, fiscal regulations are associated with the tax burden. Chapter IV explained how the taxation regime is a key constraint to growth. Using a

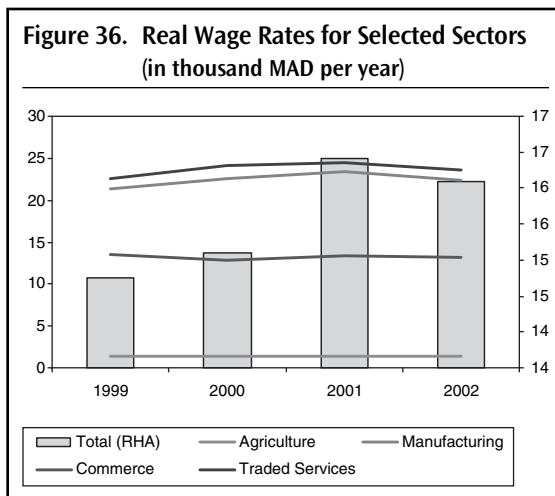
panel of countries worldwide, Loayza, Oviedo, and Serven (2005) also rank Morocco in the top third of countries with the heaviest fiscal regulations. Given this high burden and the size of its informal economy, its rate of growth should be higher than it is actually is (see Volume II, Figure V.13).

High labor rigidities compound high tax rates as a major constraint to competitiveness. Labor unions are an integral part of the political process. The new Labor Code brought more flexibility to the labor market and better regulations to prevent social conflicts, especially in matters such as the minimum wage, hours of work, the right to strike and syndicated representation, and collective bargaining. Modified regulations in the new labor code have made temporary contracts and outsourcing of services possible. Besides, they clarify the rules for worker dismissal. However, the labor costs of hiring and firing have increased, thus tightening preexisting rigidities in these fields. In addition, the political process has allowed average real wages to remain broadly constant in key sectors such as traded services, export manufacturing, commerce, and agriculture, while experiencing a mild increase overall (Figure 36).

The level of the Moroccan minimum wage is above its productivity gains, which reduces Moroccan competitiveness even further. Morocco's minimum wage has been steadily rising since 1988, achieving its present level well above that of its main competitors. The minimum wage represents more than 1.5 times GDP per capita, compared with Turkey, where it is close to 1. In countries such as Tunisia, France, and Spain, the minimum wage below their GDP per capita (see Volume II, Figure V.20). Do those increases correspond to productivity gains? The answer is no. To show this requires comparing the

effective minimum wage to the one adjusted by inflation and productivity gains, that is, the *apparent* minimum wage.⁹ Figure 37 shows how the effective minimum wage (index on dirhams per hour) has progressed much faster than the apparent minimum wage since 1984.

Finally, on the supply side, there is also low absorption of skilled workers by the private sector. This is the case for several reasons. First, there is a significant skills mismatch. The edu-



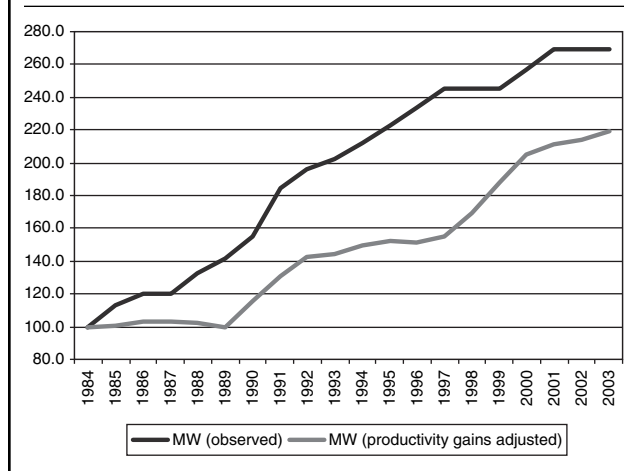
Source: Direction de la Statistique; Staff Calculations

9. Existing data allow estimates only for the manufacturing sector. The apparent minimum wage, MW, takes data of total value added in the manufacturing sector—formal or informal—and divides them by employment to estimate productivity (value added per worker). Then it adjusts such series for inflation to finally get the apparent, MW_a, which is also adjusted for productivity gains, $MW_a = MW_0 \times P_t \times CPI_t$, where P is the index of productivity and CPI is the consumer price index. The base year is 1984. Notice the apparent MW herein estimated differs from an overestimated one that would be obtained from the exclusive use of data on wages in the formal sector. This derives from the fact that, as seen above, a significant share of workers in formal firms does not receive the MW.

cation systems have concentrated on making public sector jobs accessible rather than on building adequate skills for entrepreneurial activities. Second, wages are significantly lower in the private than in the public sector, which affects the quality of management in private firms. Third, very low training by firms create an obstacle for worker rotation. In addition, public intervention lacks focus in reversing the highest unemployment rates among young new entrants to the labor market, particularly those with higher education and female workers. The prevailing characteristics of

export-oriented firms are the predominance of low-skilled workers and the low value-added per worker. In the ICA survey, the share of workers with less than 6 years of schooling reaches 45 percent for exporting firms, while only 7 percent of workers have more than 12 years of schooling. This low absorption by the private sector results in a significant brain drain. An increased share of skilled workers migrate. Between the first (before the 1980s) and second (after the 1980s) wave of Moroccan migrants, the share of Moroccan migrants holding a secondary or university diploma increased by 5 in Belgium, 3.5 in Spain, and 3 in The Netherlands, even though (with the exception of The Netherlands) they remained a minority in total migration flows.

Figure 37. MW: Effective and Adjusted to Productivity-gains
(Index Base Year: 1984=100)



Sources: HCP, Ministries of Employment and Industry; staff estimates

The Need for a New Growth Strategy

Scratch the surface of non-traditional export success stories from anywhere around the world, and you will more often than not find industrial policies, public research and development, sectoral support, export subsidies, preferential tariff arrangements, and other similar interventions lurking beneath the surface.

—Dani Rodrik, 2004

The conventional wisdom reiterates that the Government and Moroccan entrepreneurs are fully aware of the urgent need of a new growth strategy for Morocco and are formulating proposals. The centerpiece of the new industrial recovery agenda of the Moroccan government is the *Emergence* program announced last December 2005 (Box 2). It shares the sense of urgency and reportedly addresses growth issues from a sectoral perspective. On employment, the Government has also unveiled a program mainly addressing youth and first-time job seekers (Box 6 in next chapter). Both efforts are steps in the right direction, reflecting the high priority the Government is placing on growth and employment. But before dealing with the significant complementarities existing between the recommendations contained in this report and both initiatives, it is relevant to consider lessons from activist policies similar to those proposed by *Emergence* and previously followed with mixed success by East Asian countries.

Most of the debate about growth in East Asia centered on the ability of governments to identify strategic industries—those with high export potential or high learning externalities—and allocate resources to them. A well-known case of a “picking winners” policy is Taiwan, which hired the Stanford Research Institute to help select the best sectors for export promotion. Efforts to measure the effectiveness of such policies have focused on the degree to which they contributed to increasing the share of the targeted sectors in manufacturing and the effects on sectoral and interindustry productivity growth. However, the empirical evidence of success is mixed (Noland and Pack 2003). Advocates of these policies claimed that weaknesses in analytic techniques limit the measurement of externalities associated with industrial promotion, making attempts to isolate the impact of policy from

Box 2. The *Emergence* Program

The Government of Morocco announced the *Emergence* program in November 2005 (www.leconomiste.com). The program proposes an industrial strategy based on an activist policy approach. It has essentially three goals: (a) attracting new investment opportunities to Morocco; (b) developing emerging sectors into more sophisticated and competitive products; and (c) reorienting key manufacturing export toward markets that have potential for expansion. It is based on a detailed micro-diagnostic of 12 sectors and 77 activities based on their competitiveness potential. The diagnostic confirms:

- ◆ The relative importance of manufacturing activities (above 50 percent of exports, 16 percent of GDP, and 12 percent of employment);
- ◆ Their persistently high concentration (86 percent of exports) in three major sectors—textiles and leather, agro-foods, and car parts.
- ◆ The fragmentation of the manufacturing network, with small and medium firms prevailing.

The main strengths identified by the program are enhanced market access to the EU and the United States through the recently signed FTA, geographic position, good quality of life, and low labor costs. The main weaknesses identified are rigid labor regulations, high energy costs (15 percent above those of competitors), low development of sophisticated telecom services, small local and regional domestic markets, weak judicial administration, heavy taxation on private investment, a weak business environment (including Free Trade Zones), and a high significance of the informal sector. In response, *Emergence* proposes an export-led strategy based on two pillars—first, an active (*voluntariste*) targeting, though not exclusive of growth engines or *poles de compétitivité*, in a process known as “picking winners” and “choosing your battles”; and second, the competitive modernization of the existing industrial network (*mise a niveau*). Seven *poles de compétitivité* constitute the future Moroccan “world class jobs”:

1. Off-shoring services based on the advantages of geography, knowledge of languages, and moderately qualified human capital—for example, call centers and IT services under construction in the Casablanca Near Shore Park and Rabat Poles.
2. Car (and electronic) parts in free trade zones (*maquiladoras*) based on two advantages—logistics proximity (by surface), vertical integration to European firms, and low costs. It concerns the expansion of Tanger, and the creation of the Nador and North Zone.
3. Aeronautics based on the presence of two major players SAFRAN (France) for providing maintenance and R&D services to 80 percent of the Boeing industry in the African market, and SOURIAU (France) producing connectors. About 30 firms are already installed.
4. Specialized electronic parts based on size, capital intensity, vertical integration to defense, and medical and optometrist firms. This concerns the expansion of Tanger FTZ.
5. Agro-foods with regional competitive advantages in four activities but facing heavy fragmentation—fish, fruits and vegetables, soaps, and drinks. Potential for olive oil, argan oil, and orange juice. Industrial poles are proposed for Meknes-Fez, Ghareb, Souss-Draa, and the Zone Oriental.
6. Sea products based on present infrastructure and geographic proximity—shrimp, frozen products, and fresh fish.
7. Textile and artisans involving a *mise a niveau* of the sector based on targeted vertical integration, enhanced trade logistic, financing, training, and lower energy costs and incentives (Promotion Fund).

The first measures adopted by *Emergence* consist of financing facilities (improved access to the *Mise a Niveau* Fund), creation of a Guarantee Fund that supports restructuring existing guarantees on hold by the commercial banks; and technical assistance to enterprises whose guarantees are being restructured. There are three conditions for the success of this strategy—first, attracting private investment to the selected winners; second, increasing productivity through foreign technology and infrastructure investments; and third, developing a national environment that is conducive to innovation.

other factors a daunting task with many counterfactual possibilities. Yet, results are controversial (Pack 2000).

In any case, the new growth (and export-led) strategy should be based on an active productive diversification policy for Morocco. It should go beyond manufacturing to services and other dynamic activities. A productive diversification policy has much in common with an export promotion policy. In developing economies that specialize in traditional commodities, the ability to break into nontraditional, high-productivity activities is the key driver of economic growth. Consider some well-known cases. Taiwan exported little besides sugar and rice in the 1950s. Its subsequent explosive growth was based on a remarkable diversification into various kinds of manufactures. The Republic of Korea exported practically no manufactured products in the early 1960s. And Chile's dominant export was copper until the 1980s. In each case, growth was accompanied, and indeed driven, by the acquisition of capabilities in an expanding range of nontraditional activities. These and other successful cases amply demonstrate the importance of fundamentals, especially macroeconomic stability and a broadly market-oriented set of policies. They also demonstrate their limits. In each case, active intervention was needed from the state to promote exports and encourage savings and investment. Productive diversification was rarely a purely market-driven process in these experiences. Rather, it was almost always stimulated and supported by well-defined strategies and public policies of public-private collaboration. Table 5 particularly illustrates the importance of this intervention in East Asian countries and in Chile, as well as the complementary active role played by foreign direct investment (FDI) attraction and active exchange rate policies.

Can similar activist policies produce similar outcomes in MENA countries such as Morocco? Experts disagree; however, they point to several success factors that could maximize chances of replicating the positive outcomes of East Asia. For example, early identification of the market failures could help prevent outcomes that undermine policy responses. The process should not be subverted by corruption or captured by favored industries. There is no such a thing as a bullet-proof policy package that fits all countries; instead, countries must calibrate between different policy instruments permanently, because external conditions change and domestic conditions rely on political economy considerations associated with the redistribution of rents. Significant attention should be given to the quality of education as well as to reversing brain drain, as the availability of skilled professionals plays an important role in absorbing and sustaining technology improvements. Finally, steady improvements to the economic environment—macro, micro and institutional—is an obvious pre-condition for accelerated growth (Noland and Pack, 2005). This leads to two points that follow.

The new growth strategy should also be based on openness and solid property rights. This is compatible with the idea that increased productivity drives growth in the long run. And it would argue that productivity is increased through technological progress at the world level and through the rate at which lagging countries adopt it. Developing countries are generally far from the technological frontier. So openness to trade gains them access to the inputs, capital goods, and ideas that promote innovation. Openness also promotes competitiveness, forcing resources to be used more efficiently. FDI helps bring know-how and the managerial expertise of global firms, even if it is as a *sous traitance* activity, so expanded in Morocco. Firms must be able to trust contracts that they sign, the money they hold, and announcements the government makes. In such an environment, good new ideas

	Deepening Industrial Structure	FDI Strategy	Raising Technological Effort	Promotion of Large Enterprises	Exchange Rate Policies
Singapore	No protection. Very strong push into specialized high skilled without protection. Promotion for small and medium enterprises.	Aggressive and selective targeting and screening of FDI by TNCs, direction into high-value- added activities.	None for local firms, but TNCs targeted to increase R&D with generous incentive packages.	None, but some public sector enterprises shifted to targeted activities.	Active exchange rate policy.
Taiwan	High protection. Strong push into capital skill and technology intensive industry. Strong pressure for raising local content and subcontracting.	Screening of FDI, and its entry discouraged where local firms were strong; local diffusion of technology pushed.	Government- orchestrated strong technology support for local R&D and upgrading by SME.	Sporadic shift into heavy industry promoted by the government.	Active exchange rate policy.
Korea	Strong push into capital skill and technology-intensive industry, especially heavy intermediate and capital goods. Protection of local suppliers, subcontracting.	FDI kept out unless necessary for technology access or exports; joint ventures and licensing encouraged.	Ambitious local R&D in advanced industry, heavy investment in targeted technology infrastructures.	Sustained drive to create giant private conglomerates to internalize markets, create export brands, and lead heavy industry.	Active exchange rate policy.
China	Strong protection of high-productivity, new-export activities with subsidies and high tariffs, non-tariffs, and licenses. Many Chinese firms created by Government failed.	State monopolies eliminated early. Joint ventures in specific areas (mobile phones and computers). Rapid absorption of FDI-related export activities in free trade zones.	Weak enforcement of intellectual protection rights, which allowed imitating foreign technologies.	100 percent foreign-owned firms are rare. Foreign firms access the domestic market in exchange for technology transfer (joint ventures).	Significant undervaluation of the exchange rate and low labor costs.
Chile	Strong protection of agricultural modernization and new-export activities, accompanied by selective subsidies and credit support.	Rapid entry of FDI into dynamic new export industries (especially forestry and fishing).	Ambitious local R&D in off-frontier innovation industries.	<i>Fundación Chile</i> instrumental in the transferring of technologies and production systems.	Active exchange rate management with real exchange rate depreciation.

Source: Lall (2003) and Klinger (2005).

are bound to appear spontaneously without the government having to pick winners. Yet is this agenda necessarily sufficient to secure rapid technological advance in Morocco? Maybe not; and that is why additional effort is needed.

The new growth strategy should be selective and have a proper sequence that enhances its credibility. An agenda based on such a strategy should avoid the extremes of a reform approach that is either too broad or too piecemeal, both of which are condemned to fail. Broad approaches are not typical of growth accelerations, and no policy measure by itself (for example, a real depreciation) has proved to be miracle recipe for higher growth. Hence, prioritization requires focusing on a reduced set of combined key actions. An adequate sequence requires several steps. First, measures should be considered that have direct impact on the short term, dealing perhaps with government failures. Following this advice, the Government should announce new rules of the game for improving the competitiveness of the private sector, thus sending a strong message that there is no chance for growth acceleration without its active participation in the process of structural transformation of the economy. Second, the government should simultaneously build an institutional framework for dealing with market failures, the impact of which is more significant in the medium term. Overall, this would give the Government an image of urgency, commitment, enhanced governance, and transparency. Such a strategy should prevent, to the extent possible, giving in to sectoral pressures for activities that are condemned to disappear—activities that usually have a high fiscal cost and a brief impact on demand. Third, the implementation of the strategy must be coherent and participatory. The eventual creation of an Observatory for Growth and Export Development that materializes such surveillance and participation would be advisable. Fourth, the Government must continue working on those areas that may not appear to be binding constraints now but are likely to become so in the future.

To facilitate the design of the agenda attached to such strategy, the next chapter identifies the complementarities between our diagnostic and the one underlying the *Emergence* program. This is followed by a set of policy proposals grouped under a blueprint. It includes the efforts the Government is already making in most of these areas, and a small matrix of priority actions. We do not expect all of these actions to be adopted. Rather, we wish to illustrate the comprehensiveness of the effort that is needed. In any case, these ideas represent an independent opinion of the significant work already engaged in by the Moroccan authorities and the additional effort that will be needed to foster growth.

The Vision of a New Pact for Growth and Employment: Policy Proposals for Productive Diversification

Our destiny is in our hands. Our country is at the crossroads. Today it has the means to engage itself into a big national dream, shared by everybody and articulated around human development. To do this, the national collectivity has the ardent obligation to make coherent choices, accelerate the speed and depth of reforms, and definitely break with past practices and behaviors that have impeded its development.

—Kingdom of Morocco, *Fifty Years of Human Development*

A New National Pact for Growth and Employment should be based on a balanced strategy that deals with both government and market failures that limit productive diversification and competitiveness (Box 3). The government failures of key concern are: the high labor rigidities; the high tax rates on businesses, and on human capital; given the labor compact rigidities, the “fixed-peg” exchange rate regime; and the anti-export bias. These shortcomings also affect competitiveness. The generic response to government failures is to discipline policymakers by requiring non-discretion, uniformity, and arm’s-length relationships with the private sector. The market failures are information, coordination, and learning externalities. The generic response to market failures is proper incentives. We selected the priority policies and actions of a National Pact for Growth and Employment for Morocco in the Matrix contained in Table 6 (at end of text). Mainly addressing the binding constraints, the matrix also contains other policies for promoting growth and trade, improving the investment climate, and creating employment.

The findings of our diagnostic complement reasonably well those from the *Emergence* program. While the diagnostic underlying our policy proposals essentially addresses transversal issues, *Emergence* addresses sectoral issues. It is therefore relevant to find a considerable number of complementarities in the main constraints identified or nonbinding (Box 4).

Box 3. Binding Constraints to Growth

Government failures.

- a. High labor rigidities;
- b. High corporate income tax on firms, and on individual tax on the hiring of human capital;
- c. “Fix-peg” of the exchange rate;
- d. High anti-export bias

. require discipline.

Market failures.

- e. Information externalities,
- f. Coordination externalities,
- g. Learning externalities

. require incentives.

A balanced growth agenda requires discipline + incentives

A new institutional framework for productive diversification and competitiveness is a necessary first step. This proposal should not be understood as a criticism of present institutional leadership or of its capacity to lead a growth agenda in a coordinated fashion. Rather, it is as an upgraded response to a necessary set of actions that will affect vested interest, that is to say, rents. In view of the inherent uncertainty over what may or may not work, it is important to prepare “robust” institutional arrangements *before* adopting a specific agenda or policy actions. The process of productive diversification is so much about policy learning—which types of policies do or do not work

under current realities—as about entrepreneurial learning. And what is learned must be tailored to the Moroccan political economy. In the short term, the key is measures that deal with government failures. As we will see below, these actions also need to be adapted to the electoral cycle and to a proper sequencing, yet at the same time remaining flexible. In the medium term, the key is to create an effective institutional capacity.

Top leadership and robust institutional arrangements maximize the potential of revealing welfare-enhancing interventions and minimize the negative externalities discussed above. Hence, a possible institutional architecture should have political leadership from the top. Just as sound finance and fiscal probity have a high-profile political champion in the person of the finance minister, a strategy of structural transformation needs (a) a highly placed political advocate who has the ear of the Head of State (or perhaps is the Head of State himself), which would ensure that the strategy receives the priority it requires¹⁰, (b) a high-level coordination council that adopts the tough decisions in a coordinated fashion; and (c) an executing authority, a coordinating entity or ministry that takes an active role in identifying and generating new investment opportunities, acting in line with the principles enunciated above.¹¹ The coordination council would seek out and gather information (from the private sector and elsewhere) on investment; coordinate among these different entities

10. In the Republic of Korea, the role played by President Park in monitoring exports and economic performance on an almost daily basis is legendary. More recently and closer to home, tourism promotion in Morocco has been greatly facilitated by the close involvement of H. M. King Mohammed VI in the implementation of the Accord Cadre 2001–10.

11. It is important that this strategy is viewed by society at large as part of a new social compact rather than as giveaway goodies to the private sector. Another institutional mechanism to build trust and confidence in the government growth program would be to create a broadly based “Observatory” to which the coordination council would report every quarter on its activities. The Observatory would include not only parliamentarians (including the opposition) but representatives from businesses (both big and small), agriculture, trade unions, and other elements of civil society.

Box 4. How Do Diagnostics on Identified Constraints to Growth Compare to Those Found by the *Emergence* Program?

World Bank	The <i>EMERGENCE</i> Program
High labor rigidities	Labor legislation is among the main competitive weaknesses
High tax rates for businesses and for hiring skilled workers	Level of taxation is relatively heavy for investors
Exchange rate regime	No reference in <i>Emergence</i>
Severe anti-export bias	No reference in <i>Emergence</i>
Morocco ranks average in worldwide energy rankings, not a major constraint	High energy costs, more than 15% above competitors' costs
Minimum wages are above productivity gains and affect competitiveness	Relatively low cost of labor, especially among middle-workers
Acceptable level of quality of the public administration, no major constraint	Insufficient level of quality of the public administration
Corruption may become a serious constraint in the future	Ineffective functioning of the judicial administration
Financing is not a major constraint, except for poor access for some SMEs	Financing is not an issue, but access is complex for some companies
Morocco ranks average in worldwide telecom services, not a major constraint	Low availability of sophisticated telecom services
Customs access is not a major issue	Customs access is not a major issue
The FTZ at Tanger addresses several constraints successfully	Environment for FTZ could be improved
Morocco has very low crime	Morocco has a high quality of life
Market potential is in global markets	Small domestic market offers little potential so need for foreign markets

Source: www.leconomiste.com

when needed; push for changes in legislation and regulation; have the capacity to provide complementary public goods; suggest targeted fiscal incentives for new activities when needed (and provide the rationale); and credibly bundle these different elements of support along with appropriate conditions (perhaps along the lines of the well-known *Contrats Programmes*) in Morocco. To facilitate the working of the council, it should be kept small and preferably should be composed of key economics ministries, while headed by the *Premier Ministre*. The executing entity should have its own staff of technocrats.

Addressing Government Failures

Rigidities of the Labor Regime

Reform of the labor compact may be necessary though not politically feasible in the short term, perhaps not even sufficient for addressing the scope of the growth and employment

challenge. In 2006, a pre-election year, it is hard to imagine political conditions that might reverse some of the additional rigidities introduced by the recently approved labor code, as discussed above. Hence, the following proposals take political economy considerations into account:

- *On labor rigidities and competitiveness.* The two most-pressing policy issues in this area are to keep real minimum wages constant over the medium term (especially while unfavorable external shocks persist) and prevent further distortions (for example, in territorial minimum wages). Medium-term priorities are to bring renewed dynamism to the collective process of negotiation, consider the introduction of an unemployment insurance scheme in exchange of a minimum taxation mechanism, and reform social security with a view toward reducing the high gross income replacement rate.

Taxation Regime

- *On the corporate income tax.* A rate reduction is needed. This can be viewed from two perspectives. First, the rate should follow the present regional trend in corporate taxation. This fits with the modern efficiency view, based on the Laffer curve, that to promote growth and generate employment, states should adopt a neutral tax regime with a broad base and relatively low rates (Le 2006). Hence, a practical approach would be gradually lowering the CIT rate to a level in line with other countries—that is, inside the 20 to 30 percent bracket. Second, with an eye toward fiscal sustainability, the issue of revenue adequacy has to be born in mind. Tax regimes are already under stress following scheduled tariff reductions from FTAs and a persistently low VAT productivity arising from an excessive number of tax exemptions. Hence, from a fiscal sustainability point of view, a proposed reduction in the CIT tax would not only require an accurate estimate of its fiscal impact, but of compensatory measures under a broader fiscal reform effort. Fiscal sustainability is discussed additionally below.
- *On the personal income tax (IGR).* Reducing the IGR rate, especially in the top tax brackets, is essential to diminish the negative effect of this tax on the hiring of human capital in the short term. This measure is long overdue to the private sector, the Government having announced it in 2004. What matters for fiscal accounts is the *average* revenue generated by a tax; what matters for distortions is the *marginal* tax rate. The rapidly rising marginal rate of the IGR has the inconvenient effect of raising a very little tax revenue on average, but it generates a very large distortion through the high marginal rates.

Exchange Rate Regime

Given limitations on increasing flexibility in the labor market, the Government authorities might adopt a more flexible exchange rate regime taking a view toward a real depreciation. The process of considering a more competitive exchange rate policy becomes that much more binding in light of that the present leading export activities. Textiles, agriculture, and fisheries face significant negative shocks associated with increased international

competition, unstable rain patterns (cut short cereal collection by half in 2005), and environmental limitations, respectively.

Some lessons from Tunisia's early experience in managing an active exchange rate policy might be relevant for Morocco. While pursuing a constant real exchange rate rule (CRER) between 1991 and 2001, Tunisia's economic performance was successful. It preserved competitiveness while reducing inflation. Inflation declined to below 2 percent in the early 2000s, while real GDP and real non-energy export growth averaged 4.8 and 7.4 percent, respectively. Moreover, no parallel exchange rate market emerged during this period. This is not a standard outcome of CRER theoretical models, which predict increased inflation. Tunisia's economic performance surpasses other countries applying a similar scheme, for example, Brazil and Yugoslavia. Why did Tunisia not experience a surge in prices? Essentially, there are three reasons—first, prudent macroeconomic management; second, income policies that contained wages and kept prices low; and third, “luck” in the absence of significant adverse shocks during this period (Fanizza and others, 2002). The fiscal deficit was reduced from 6 percent of GDP in 1991 to 2.4 percent of GDP in 2001. The reduction helped to contain demand on nontraded goods; credit was broadly set in line with domestic demand (nominal GDP growth); and limited flexibility was preserved in wages (negotiated every three years) and administered prices (making up to a third of the CPI basket).¹² This helped to prevent wage-price spirals. Finally, the terms of trade remained almost unchanged during the first half of the 1990s, and then mildly deteriorated by about 8 percent during the second half. Tunisia is currently exploring a more flexible exchange rate regime.

Favoring a real depreciation implies that the greatest returns to discovering high-productivity activities lie among tradable goods and services. This is because such activities can cater to the global market instead of the small domestic market. Hence, each discovery can be scaled to a much larger extent, making it much more valuable from a social point of view. In addition, it is harder to create the incentives for self-discovery in the tradable rather than in the nontradable sector. This is because an innovator in the nontradable sector, almost by definition, will become a monopolist in that activity until copied by some other entrant in the local market. This period of monopoly may help create the rents that constitute the payoff to entrepreneurship. By contrast, the first to produce some tradable good or service in Morocco will generally not be the first in the world, and hence will be participating in a market where competition already exists. There is necessarily little room for entrepreneurial rents to stimulate experimentation and self-discovery in this sector. In this context, real exchange rate depreciation would increase the return to such entrepreneurship and act as a subsidy to self-discovery in tradables. Its impact on aggregate productivity and economic growth can therefore be seizable.

Options, preconditions, and operational issues for exiting the current peg for Morocco are described in detail in IMF, 2005b. However, there is a fundamental difference between

12. Curiously, Morocco has a similar percentage of administered prices on its CPI basket: The prices still administered (and their weight) are: cereals (9 percent), sugar (2.4 percent), tobacco and cigarettes (2.5 percent), heating and water (5.9 percent), medical consultation (0.7 percent), paramedical services (0.5 percent), medicines (3.2 percent), hospitalizations (0.2 percent), oil derivatives for private transportation (4.5 percent), and public transportation-railroad (2.3 percent), for a total of 31.2 percent.

the neutral IMF stance for the real exchange rate (and not excluding the possibility of a real exchange rate appreciation) and the active stance toward a real exchange rate depreciation that this CEM proposes. As a result, the nature of central bank interventions in the foreign exchange market will differ according to the horizontal band and reserve accumulation targets that monetary authorities will set up in correspondence with the desired inflation rate.

An inflation targeting mechanisms is an adequate complementary policy tool of a flexible exchange rate regime in the medium term. This is so because a tight monetary and fiscal framework will be needed given that the exchange rate, under an alternative managed float regime, will no longer be the anchor for domestic inflation. In a similar vein, exchange rate policy is just one among several policy instruments considered in this report to enable successful productive diversification cum export promotion policy. Among other instruments, tariff reductions are particularly relevant to a proper sequencing with movements in the nominal exchange rate because these are also equivalent to a real depreciation, especially in the short term.

Anti-export Bias of the Trade Regime

The choice to eliminate the anti-export bias and open the domestic market through preferential agreements involves multiple challenges that warrant policymakers' attention.

- *The economic costs of trade diversion should be contained in the short term.* The Government should consider unilaterally reducing its MFN tariffs in relation to third countries and nontariff barriers, especially those affecting manufacturing products. Simultaneously, it needs to reduce tariff dispersion and the currently high degree of tariff escalation across different stages of transformation, which gives rise to very high effective rates of protection. The opening of the domestic markets is selective in the sense that only partner countries can sell their products in Morocco at low import tariffs, while third country exporters continue to face high MFN rates. This asymmetry leads to the diversion of trade flows from more efficient third-country producers to less efficient partner-country producers, resulting in a loss of tariff revenues without consumers benefiting from the lower purchasing costs. This measure has a good precedent in the December 2005 reduction of tariffs on textiles.
- *The liberalization process pursued in the communications sector should extend to other services sectors.* This should include the transport and financial sectors in order to foster competition and increase the efficiency of service providers. Services tend to be the most dynamic sector promoting growth as a result of FTAs. Low-cost service operators can generate substantial export revenues as demonstrated by Morocco's call center industry; and they can reduce input costs for manufacturing firms, thus improving competitiveness in international markets.
- *In the medium term, the Government should embark on a strategy of agricultural tariff reductions that gradually increase the exposure of farmers and agro-processors to international market forces.* Tariff protection should be substantially reduced with a view to fostering a restructuring or closedown of value-subtracting firms. The high effective rates of protection for agricultural and food products are bound to increase further as tariffs on industrial inputs are phased out under the Euro-Mediterranean

Agreement. Urgent action is required in sectors such as meat processing, which show negative value added at international prices. Fruits and vegetables also have significant export potential. Moreover, the Government should ensure full compliance with Morocco's obligations under WTO agreements, including with respect to tariff bindings and variable levies in order to enhance the credibility of its trade policy. The opening of negotiations on agricultural tariff reduction between Morocco and the EU in February 2006 is a step in the right direction.¹³

- *Finally, the adoption of simple-to-administer harmonized rules of origin and technical standards across different preferential agreements could markedly facilitate trade.* So far, Morocco's choice of international integration through preferential bilateral agreements is largely static because it focuses on tariff reductions among partner countries.

How can Morocco move from a low-growth/high-unemployment equilibrium to a high-growth/low-unemployment equilibrium? The answer deserves a few words on possible sequencing and transition steps. While measures to address market failures can be inserted into a medium-term agenda (see the following chapter), defining proper sequence for dealing with the four government failures in the short term is a more complicated task. Taking into account the political cycle, the period for implementing those measures might be considered first in the short term (up to mid 2007) and then in medium term (up to the end of 2008). Of course, adjustment to the timing of proposed measures can always be modified.

- *Ideally, the Government would first create an institutional framework to take leadership on the new growth strategy.* Simultaneously, it should move on the four government failures identified, thereby sending strong signals to the private sector of its willingness to prioritize its growth agenda.
- *However, two important challenges require measures that can be implemented at the outset.* First, there is limited potential to reduce labor rigidities within the ongoing social dialogue and complex discussions over the norms of the new Labor Code. So, acknowledging these limitations, we propose to keep real minimum wages constant, rather than create permanent distortions in the form of territorial minimum wages, as well as renewed dynamism in the process of collective negotiations.
- *Second, now is probably not the moment to make the tough transition between two exchange rate regimes.* Yet taking the political economy of this complex matter into account, preconditions can nonetheless be established. A real exchange rate depreciation is critical to an export-led strategy. In fact, it is often substituted for export subsidies and other fiscal incentives. Given the low level of inflation and high international reserves, as well as offsetting forces that would prevent any inflation surge or exchange rate misalignment in the short term, the conjuncture is not in itself adverse for a change of regime, *especially if jointly implemented with other proposed measures.* However, regime change during a pre-electoral cycle is technically complex

13. An innovative, gradual asymmetric approach to negotiations has also been adopted, based on the mutual definition of a negative list of products. In its own list, Morocco has reportedly included cereals, meat, milk products, and sugar. Moroccan export products that could benefit from enhanced access would include tomatoes, green beans, strawberries, maize, and cucumbers.

and may not be realistic from a political economy point of view. This could jeopardize the necessary domestic consensus that would be required before the elections in September 2007. In addition, moving toward a flexible exchange rate regime in Morocco's case would de facto be closely related to the decision to proceed to the gradual full opening of the capital account. The preconditions and timing of this process are being carefully weighed by the Moroccan authorities. Hence, assuming that the change of exchange rate regime is not achieved during the current administration and that other preconditions for fully opening the capital account are also satisfied during this term—including the minimum political consensus—nothing would prevent such a measure from being adopted during the early stages of the next administration. This choice would also leave room for further fiscal consolidation and strengthening of the banking system.

- *This leaves trade liberalization and tax modernization as the two most likely reforms to be adopted in the near term.* The elimination of the anti-export bias is better option than export incentives. Solid progress in this direction would also reduce the need for their use (or their amounts). The possible components of trade liberalization reform were outlined above. Regarding the timing proposed in the reduction of tariff and nontariff barriers, our proposal does not call for a “big bang” but for acceleration in the gradual approach already adopted by Moroccan authorities. For its part, tax reform should be considered as part of the significant efforts that the Government is now making to strengthen fiscal sustainability (see below). In addition, several measures addressing tax reforms were introduced with the 2006 Budget. These include the approval of a new tax code, some VAT rates simplification, expansion of the IGR threshold for the deduction applied to first-time workers (from MAD4,500 to MAD6,000), interest deductions on housing loans, and the improvement conceded to retirees regarding reduced contributions to social security costs. Despite these positive measures, the core components of a comprehensive tax reform are still pending. The direction of reform points toward a more neutral system taxed on an increased weight of the VAT in the overall taxation structure—a lower CIT, a flatter IGR, a simplified VAT to a maximum of two rates, the gradual elimination of tax exemptions (accounting for about 3.4 percent of GDP as recently published under the 2006 Budget Law), and a minimum tax on (informal) businesses. The VAT has the advantage that it does not discriminate against human capital, and it does not completely exempt the informal sector. While the informal sector does not pay the VAT on its sales, it is unable to deduct the VAT it pays on its purchases of goods and services factors under discussion.
- *Finally, the Government must preserve its ongoing actions already addressing the five potential binding constraints identified in the medium term.* This concerns supporting measures aimed at improving (a) the quality of education (education reform, literacy campaigns, and improvement to the curriculum of vocational training); (b) reducing expensive logistics costs (port and sea shipment charges expected to be significantly reduced following the opening of the Tanger-Med port in 2007); (c) facilitating access to finance for Small and Medium Enterprises (SMEs) (ongoing work on the supply and demand side of credit lines to SMEs); (d) improving conditions for attracting FDI (easier real estate registry, improved single-window of the

regional centers for investment—CRIs),¹⁴ and simplification of business procedures¹⁵; and (e) curbing corruption (following the ratification of the UN Convention against Corruption, the design of the national Anti-Corruption Strategy, and the establishment of a national independent executing body).

Addressing Market Failures

Designing the requisite mechanisms and institutions for dealing with externalities is a complex task that emphasizes process over specific policies. Several aspects need to be recognized. First, the Government does not have privileged information on either business opportunities or current market failures. These are more likely to be disseminated broadly across society. The challenge is to create *processes* that elicit that information and provide the adequate policy response. The emphasis needs to be the policy processes that deal with the problems, as well as on specific instruments that address particular issues. These processes cannot be top down, lest the Government proceed with inadequate information. Second, these processes and instruments have to be horizontal rather than too vertical. If not, the design may be captured by business groups' vested sectoral interests. The right solution involves strategic cooperation between the private sector and the Government in which the bureaucracy is both autonomous (to avoid capture) and embedded in the private sector to elicit the necessary information about opportunities and constraints. Third, addressing the market failures identified here will require strong political leadership from the top, as well as the high-level coordination council that is proposed above. The selection of activities to be promoted needs to be transparent and accountable. Fourth, lessons from policies adopted in the in the tourism sector and the Tangier Free Trade Zone (where there has been rapid expansion of exports and employment) are critical in order to reproduce their successes. Constraints that were preventing development from taking place seem to have effectively been removed.

Thus, the Government should not generally engage in a priori selection of *sectors* for special support, but instead should institute a competitive process whereby certain *activities* will be supported. There are some instances, on the other hand, where a priori selection

14. CRIs have two windows: one for business creation and another for investors. By the end of 2004, CRIs had created 14,265 firms and issued seals of approval to 4,413 investments. This is in addition to the 107 investment projects approved by the Interministerial Commission for Investment. Based on a new manual prepared by the National Committee of the CRIs and USAID consultants, 41 investment procedures were streamlined and unified countrywide in March 2006. These procedures affect nine areas, including tourism, mines, environment, real estate access (national and municipal), urban construction permits, urban project agencies, cadastre procedures, and major investments above MAD200 million.

15. A recent report by the EU on innovation policy trends offers a sanguine account of rapid developments in Morocco when compared to its MENA neighbors (European Commission, 2005). According to the report, Morocco stands out as the veteran in the region. It is the only country to have carried out a formal evaluation of its science system in 2003. It has the lead on four trends—privatization, emergence of equity and private ventures, technology-related FDI, and development of university-related incubator centers. However, the report also recognized that FDI amounts are small; only a few “exits” have graduated from start-up incubator companies; new coordination committees on innovation are too recent for estimation of their impact; high tasks have the potential to employ available high-skilled graduates; and capital seed and venture finance are still not fully appreciated by SMEs and commercial banks.

of sectors does make sense. For example, Morocco has ample investment opportunities available in tourism. This sector requires strong public investment and support. Similarly, clear opportunities for business development related to logistics and port services in the free trade zones also require public investment. To a certain extent, these are special cases that lie at the intersection between horizontal policies to induce discovery and vertical policies to deal with coordination failures addressed by *Emergence*. This is because discovery in these cases requires strong collective action, so subsidies for private investment are not enough for new activities to develop and expand. Hence, policies should be as horizontal as possible and as vertical as necessary.

Morocco has to harmonize presently dispersed, overlapping, and non-focused industrial policy regulations that have little to do with productive diversification, and rather conform to a traditional import-substitution strategy. These derive from a multiplicity of investment promotions, industrial zones, free trade zones, and other special regimes. These shortcomings lead to waste and discrimination. For instance, an export firm specializing in artisan products in Tangier benefits from (a) reduction of the corporate tax for production for 5 years; (b) total exoneration of the corporate tax over exports for 5 years, (c) gradual reduction of 50 percent over the next 5 years; and (d) full corporate tax exemption over expenditures that lead to the development of the Tangier region. Firms located in the Tangier FTZ have additional benefits.

In addition, Morocco has to take full advantage of the EU-sponsored *Mise a Niveau* program of manufacturing firms, whose performance in the past has been disappointing. Initiated in 1997, the program aims at modernizing the industrial environment, strengthening support systems, and promoting competition among and competitiveness of industrial firms. Focused on helping firms to adjusted to the new environment opening up with the implementation of the EU agreement, the program mainly offers resources and technical assistance. Unfortunately, program outcomes have not met expectations so far. A recent report recognized that until 2005, the volume of resources disbursed (14 million euros) and the number of beneficiary firms (85) was very small for Morocco. The same report identified key factors explaining such results: (a) Insufficient involvement and ownership by the Moroccan state. (b) Long delays in the creation of the counterpart financing mechanism and multiple restrictions on their use. (c) Insufficient financial stimulus offered as incentive for financial transparency by firms. (d) Institutional rigidities and poor management of the program (Agence Française de Développement 2005). Obviously, these are shortcomings for Morocco to avoid.

These set of recommendations can be wrapped out in a new architectural setup of productive diversification summarized by Rodrik's ten principles in policy design for maximum effectiveness (Rodrik, 2004). These are shown in Box 5. In summary, a productive diversification policy needs the following elements in order to address market failures.

- Clear coordination mechanism by a leader.
- Carefully selected fiscal incentives (as transversal as possible and as sectoral as needed) within a fiscally sustainable envelope.
- A competitive, transparent, and accountable selection process of activities deserving to receive incentives.
- *Contrats Programme* when financing is provided, in order to match resources against outcomes of activities supported.

- An annual and transparent review of performance of firms benefiting from annual budget allocations.
- Improved capital risk financing.
- Strengthened property rights.
- Incentives to encourage firms in new activities to increase the supply and quality of private training. This involves subsidizing firms that provide on-the-job training for general skills, or when firm-specific and general training cannot be easily distinguished, to subsidize private training facilities that provide the required skills.
- Last but not least, strict enforcement of sanctions considered in the *Contrats Programme*. Firms not reaching target commitments in their program must see their incentives removed.

Box 5. Applying Rodrik's Ten Principles to a Productive Diversification Policy in Morocco

1. Incentives should be provided only to “new” activities. The main purpose of the policies in question would be to generate new products of comparative advantage for Morocco. Hence, incentives ought to focus on economic activities that are new to the economy. “New” refers to both a new product and a substantially new process for producing an existing product—those that could qualify as discoveries. This differs from the traditional sector-based support or support to SMEs, the policies of which are based on the criterion of size—not on whether the activity in question has the potential to spawn new areas of specialization.
2. There should be clear and quantifiable benchmark indicators for success and failure set up ex-ante in a *Contrat Programme*. It is in the nature of the entrepreneurial “trial-and-error” process that not all investments in new activities will pay off. In fact, one can even expect only a small fraction of “trials” to eventually be successful. It is often enough to have one product success to pay off for scores of failures. Hence, every publicly supported project needs to have a *Contrat Programme* ex ante of what constitutes success and failure, and the criteria for monitoring it. Ideally, the criteria should depend on productivity, but as that can be notoriously difficult to measure, other indicators are needed.
3. There must be a built-in sunset clause. Related to the above, it is important that resources (both financial and human) not remain tied up in activities that are not paying off. Hence, the *Contrat Programme* of every publicly supported project needs to include an automatic sunset clause for withdrawing support after appropriate time has elapsed.
4. Public support must target as much transversal activity as possible, and as many sectoral activities as needed. The targets of public support should be viewed not as sectors, but as transversal activities that favor several sectors simultaneously. This facilitates structuring the support as a corrective to specific market failures instead of as generic industrial policies. So, rather than providing broad sector incentives for, say, textiles, fishing, and so forth, government programs should subsidize infrastructure investment, bilingual training, feasibility reports, adaptation of foreign technology to Moroccan conditions, risk and venture capital, and so on.
5. Activities that are subsidized must have the clear potential of providing spillovers and demonstration effects. Public support for an activity should be contingent on a rigorous analysis of its potential to crowd in other complementary investments or generate positive informational or technological spillovers.
6. The executing entity promoting the new policy must be autonomous and with demonstrated competence. The authorities need to have enough autonomy and independence to insulate themselves from lobbying, design their work agenda appropriately, and have

(continued)

Box 5. Applying Rodrik's Ten Principles to a Productive Diversification Policy in Morocco (*Continued*)

- the flexibility to respond to changing circumstances. This in turn requires a prior track record of professionalism, technical competence, and administrative effectiveness.
7. The executing entities must be monitored closely by a principal with a clear stake in the outcomes and who has political authority at the highest level. Autonomy should not mean lack of accountability. Close monitoring (and coordination) of the promotion activities by a "principal" who has internalized the agenda of economic restructuring and shoulders the main responsibility for it, is essential. This "principal" could be the prime minister himself and/or whoever has the ear of His Majesty the King.
 8. The council and executing agencies carrying out promotion must maintain channels of communication with the private sector. Autonomy and insulation do not mean that bureaucrats can maintain arm's-length relationships from entrepreneurs and investors. In fact, ongoing contacts and communication are important in providing public officials with have good information on business realities, without which sound decisionmaking would be impossible.
 9. Optimally, mistakes that result in "picking losers" will occur. Strategies of the sort advocated here are often derided because they lead to picking losers rather than winners. Building safeguards against this minimize the chances that mistakes will occur. If the Government is making no mistakes, it means that it is not trying hard enough.
 10. Promotion activities need the capacity to renovate by themselves so that the cycle of discovery becomes permanent. Just as there is no single blueprint for undertaking promotion, the needs and circumstances of productive discovery are likely to change over time. This requires that the agencies carrying out these policies have the capacity to reinvent and refashion themselves. Morocco already has an innovative entity in Techno-Park, a public agency in charge of identifying and incubating new products but whose performance so far is still hard to evaluate.

In the medium term, other measures include no further approval of tax exemptions, strong legislation and enforcement of property rights,¹⁶ increased resources to R&D, an expansion of Techno-Park in incubating innovative products, and the extension of some benefits provided to the Tangier FTZ to other productive zones. Thus, delocating investment outside the FTZ might take "investment contracts" on new activities outside the FTZ. These "contracts" would specify the fiscal regime that applies for a limited time and, following best practice in FTZ policy, would not offer full tax exemptions. Contracts would, however, offer security to prospective investors. These could include temporarily lower tax rates for investment in new activities in services (for example, corporate income tax rates of 10 to 15 percent for 5 to 10 years). In addition, Morocco would adjust the fiscal incentives it grants to FTZ enterprises in order to ensure compliance with its commitments under the WTO agreement.

Finally, the amount of resources involved in this activist policy agenda should be small so as not to affect fiscal sustainability, and it should be published so as to maintain trans-

16. On another example of the importance of addressing information externalities, the proceedings of a January 10, 2006 seminar on MENA ICT project incubators in Casablanca concluded that one of the main obstacles to develop new projects in the region is that innovators feel completely unprotected so as to motivate them to register their patents, due to the lack of property rights legislation. So, their patents are rather registered in the U.S. or in the European countries.

parency. The Government already has a well defined fiscal consolidation path aimed at adopting measures to bring the fiscal deficit toward 3 percent of GDP and reduce the public debt-to-GDP ratio to at least 65 percent of GDP by 2008. *Achieving this milestone successfully would place Morocco's debt close to obtaining investment grade.* Accomplished efforts to curb expenditures include the Voluntary Retirement Program of public servants, the preparation of a medium-term expenditure framework, the review of personnel positions, the introduction of an integrated expenditure cycle, and the reform of the law regarding concessions of the state.¹⁷ To prevent fiscal disarray, as has happened in other emerging export-led economies (for example, Costa Rica in the 1980s, with its export subsidies [Hoffmaister 1992]), it is critical to have sound estimates of the fiscal impact of resources involved, and of those not perceived by tax exemptions (similar to those published in the 2006 Budget Law). This amount should be small so as not to substitute mainstream financing mechanisms. It should be transparent, that is, published as a special budgetary window in the budget law. Its corresponding allocations should be calibrated according to the criteria mentioned above, and then monitored and evaluated. This will not only preclude fiscal uncertainty, but accountability will be respected regarding the discipline needed in the use of resources.

On Promoting Employment

A New Employment Initiative created by the Government in September 2005 and new tax regulations adopted in the Budget Law regarding the IGR 2006 are positive steps. They partly address these issues (Box 6).

The Employment Initiative contains adequate policies to address first-time job seekers, but still leaves room open for other areas. To begin, the Government will have to solve some obstacles in facing the implementation of its employment initiative. These obstacles mainly refer to the one-year obligation to register with the National Association of Public Employees before having access to the First Job Contract, and the potential significant wasted resources if projects and loans are not duly mentored and monitored. In fact, the employment initiative already faces an existing stock of significant loans in default from a similar program approved years ago. In addition, the initiative does not address other pressing employment issues, including youth and female unemployment, the lack of workers' unemployment insurance, and the increased fiscal burden of social security, which affects prospects for diversifying the use of savings by employees. To deal with these latter issues, we propose considering an unemployment insurance scheme, temporary reduction of the minimum wage applied to both categories, and the need to study social security reform based on at least two actions—comprehensive reform of the system with a view to reducing the gross income replacement rate—70 percent compared with a 60 percent worldwide average (Robalino 2005)—which the average full-career worker can expect in

17. A few early achievements in 2005 include the approved concession of urban lightening, urban waste management, urban transport and irrigation projects; the approval of the Law on the Financial Control of Public Enterprises; the issuance of new regulations regarding internal audits in the state; several texts regarding the reform of public administration; and the administrative deconcentration of public services.

Box 6. Recent Employment Measures of the Government

In late September 2005, the Government announced its Employment Initiative (EI). The program largely focuses on microeconomic incentives with a view to creating 200,000 job opportunities, especially among young unemployed to set up their own businesses in the next three years. These instruments stem from the recommendations of an "Employment Forum" with the participation of representatives of the unemployed and NGOs. Four main policies were approved.

- ◆ A First Job Contract to enhance the Training Insertion Contract offering a first job for young unemployed, especially those unemployed for more than 12 months. It awards incentives for enterprises to hire young unemployed under a short-term training contract that can be extended beyond the current 18 to 24 months.
- ◆ A self employment program targeting young unemployed willing to create their own business, and small enterprises operating in the informal sector but desiring to become formal. The Government offers 10 percent of the funds required for the project up to MAD15,000 and banking loans up to 90 percent of the investment, with a ceiling of MAD250,000, both guaranteed by the state.
- ◆ Regional employment funds to be managed locally by elected institutions, chambers of commerce, the regional investment centers (CRIs) and ANAPEC.
- ◆ An *Observatoire National de l'Emploi* with a database of indicators on labor supply and demand, and labor intermediation activities. The database will be updated in real time.

In addition, the IGR tax deduction threshold and exemption from social security contributions of first-time job seekers was increased from MAD4,500 to MAD6,000 in the 2006 Budget Law, but temporarily up to 3 years.

the future under today's pension rules, and strengthening the mandatory payments scheme. This could precede the opening of innovative defined-contribution schemes. The rationale for introducing a reduced minimum wage is to take into account lower marginal productivity among young workers, and to make a persuasive argument for employers to hire females, letting them demonstrate their skills on the job.

This CEM highlights the difficult constraints faced by Morocco in consolidating its entrance into globalization while fostering growth and employment. It shows how the status quo is a risky strategy for Morocco, a reality well illustrated by the significant growth slowdown in 2005. For that reason, the very focused policy agenda described here requires, in addition, careful prioritization and sequencing. Possibly, it should begin with strong initial measures that send new signals to the private sector while also addressing government failures. These measures should simultaneously be accompanied by medium-term institutional reforms aimed at market failures. Not only the design but the implementation of this new agenda must be consistent. The World Bank recognizes the complexity of creating this vision for Morocco. It will continue to offer its support to officials in the design and development of components of this strategy for higher growth and employment.

Table 6. Toward a New Pact for Growth and Employment in Morocco: Matrix of Priority Policies and Actions

Policy Objective	Short Term (up to mid 2007)	Medium Term (up to end 2008)
<p>Setting up a new institutional framework for growth and employment.</p>	<p>Official appointment of the key actors:</p> <ul style="list-style-type: none"> ◆ Creation of a high-level coordination council, with participation of the private sector, to prepare a Strategy of Productive Diversification (National Pact for Growth and Employment). ◆ Designation of an authority in charge of the draft design and implementation of the Strategy. <p>Design and approval of the National Pact for Growth and Employment Strategy. Key components of such strategy are the policies and actions to address market and government failures</p> <p>Creation of the National Observatory for Growth and External Trade.</p>	
<p>Addressing government failures and enhancing competitiveness</p> <p>Reducing labor market rigidities.</p> <p>Reducing high taxation of human capital.</p> <p>Promoting exchange rate competitiveness</p>	<p>Keeping real minimum wages constant in the medium term and no approval of distorted territorial minimum wages.</p> <p>Design and gradual implementation of a neutral tax modernization reform based on a reduction in corporate income taxes, a lower IGR, a simplified VAT, elimination of tax exemptions, minimum tax on informal businesses, and tariff reductions from trade liberalization.</p> <p>Development of a program of actions to comply with pre-conditions to adopt a more flexible exchange rate regime, and to develop an inflation targeting mechanism.</p>	<p>Renewed dynamism in the process of Collective Negotiations.</p> <p>Gradual implementation of the remaining actions of the tax reform.</p> <p>Change toward a more flexible and competitive exchange rate regime (with a view toward a real depreciation).</p> <p>Development of an inflation targeting mechanism to maintain inflation low and support a more flexible exchange rate policy.</p>

(continued)

Table 6. Toward a New Pact for Growth and Employment in Morocco: Matrix of Priority Policies and Actions (Continued)

Policy Objective	Short Term (up to mid 2007)	Medium Term (up to end 2008)
Reducing the anti-export bias of the trade regime.	<p>Accelerated reduction of MFN high tariffs, of tariff dispersion and of tariff escalation (effective protection), especially of those affecting manufactured final products.</p> <p>Reduced tariffs with partners not having signed a preferential arrangement in order to contain trade diversion.</p> <p>Accelerated reduction of the liberalization of other services, especially transport and financial, in order to foster their competitiveness, increase the efficiency of service providers, and lower costs.</p>	<p>Design and implementation of a new strategy for tariff reduction of agricultural and food products, and full compliance with WTO agreements, especially those on tariff bindings and variable levies.</p> <p>Harmonization of the coverage of preferred trade agreements, especially their rules of origin and technical standards</p>
Addressing market failures	<p>Adoption of a set of new policies on (a) fiscal incentives (as transversal as possible and as sectoral as needed) to promote diversification; (b) a competitive, transparent and accountable selection process of activities deserving to receive them; (c) <i>Contrats Programme</i> to monitor incentives against outcomes of activities supported; (d) annual review of performance of firms; (e) improved capital risk financing; (f) strengthened property rights; and (g) additional incentives to encourage firms in new activities to increase the supply and quality of private training.</p>	<p>Support to the implementation of policies dealing with externalities including:</p> <ul style="list-style-type: none"> ◆ No further extension or approval of any tax exemption, except for those activities considered in the strategy of productive diversification. ◆ Increased public resources to research and development, and setting of new criteria for promoting strengthened linkages between public research centers and private firms. ◆ Mainstream innovation policy to projects supported by Techno-Park and other ICT incubator centers. ◆ Complete realignment of incentives given to the Tangier FTZ toward other zones

Other policies aimed at preventing potential growth constraints

Preserving sound macroeconomic fundamentals.

Continue with the agenda of fiscal consolidation—adopting measures to bring the fiscal deficit toward 3 percent of GDP and reduce the public debt-to-GDP ratio to at least 65 percent of GDP.

Continue with the agenda of fiscal consolidation with a view to obtain investment grade on Morocco’s external public debt.

Removing trade logistic constraints, in particular costs for ports and maritime passage.

Reduce port fees as well as the shipment fees of crossing the Strait of Gibraltar to be in line with those applicable by other ports and major strait crossings in the regions.

Complete Tangier-Med project on time, so as to guarantee its opening in 2007.

Reduce transaction costs, tighten standards for port operators, and improve land-based procedures for quality service delivery by port service providers, mainly in the port of Casablanca.

Revert on-going deterioration of corruption indicators

Complete the design of the National Anti-corruption strategy
Create an independent Anti-corruption Commission

Strong implementation of the Anti-corruption Strategy.

Improving SME access to financing

Support official efforts to optimize use of available financing

Revision of laws pertaining to collateral and guarantees applied to SMEs.

Improve the quality of education

Pay attention to policies aimed to increase graduation and employment rates of high school, higher education and vocational training. In particular, consider adoption of contractual frameworks between the Government, and Universities and vocational training centers based on graduation rates

Shift the high-level education curriculum toward technical areas in the private sector.

Other policies aimed at improving the business climate

Simplifying business procedures and improving labor training.

Creation of a unique identifier for each enterprise (Trade Registry, statistics, CNSS, taxes, customs, OFPPT, etc.)

Reform of the judicial procedures to strengthen enforcement of court decisions pertaining to contracts and more vigorous prosecution of violators, and sanctions for bad checks. Establish a list of non-payers.

Development of a credit information system.

Reduction of limits on personal collateral required of entrepreneurs, in order to preserve their patrimony.

(continued)

Table 6. Toward a New Pact for Growth and Employment in Morocco: Matrix of Priority Policies and Actions (*Continued*)

Policy Objective	Short Term (up to mid 2007)	Medium Term (up to end 2008)
Expanding access to real estate.	<p>Acceleration of government programs to refurbish real estate and make properties available to firms.</p> <p>Decentralization at the regional governors' level, of decision making on marketing and sale of publicly owned sites.</p>	<p>Design a program to encourage SMEs to expand staff training and facilitate access to training, while simplifying existing training opportunities given to sectoral associations.</p> <p>Reduction of the number of statutes and oversight agencies.</p> <p>Complete an inventory of sites available for the real estate pool, placement of such sites in a status of availability, and provision of sites suitable for use as logistical platforms.</p>
Other policies aimed at creating employment		
Increasing formal employment and improving job conditions.	<p>Design and implementation of a new human resource management policy for the civil service.</p> <p>Strong implementation of new policy recently issued by the Executive regarding first-time job seekers.</p> <p>Consider a temporary reduction of the minimum wage vis-à-vis the youth and female workers.</p>	<p>Consider the introduction of an unemployment insurance scheme in exchange for a minimum taxation mechanism.</p> <p>Reform of the social security system with a view to reduce the too high gross replacement rate (70 per cent) and to strengthen the mandatory payments scheme, coupled with the opening of innovative defined-contribution schemes</p>

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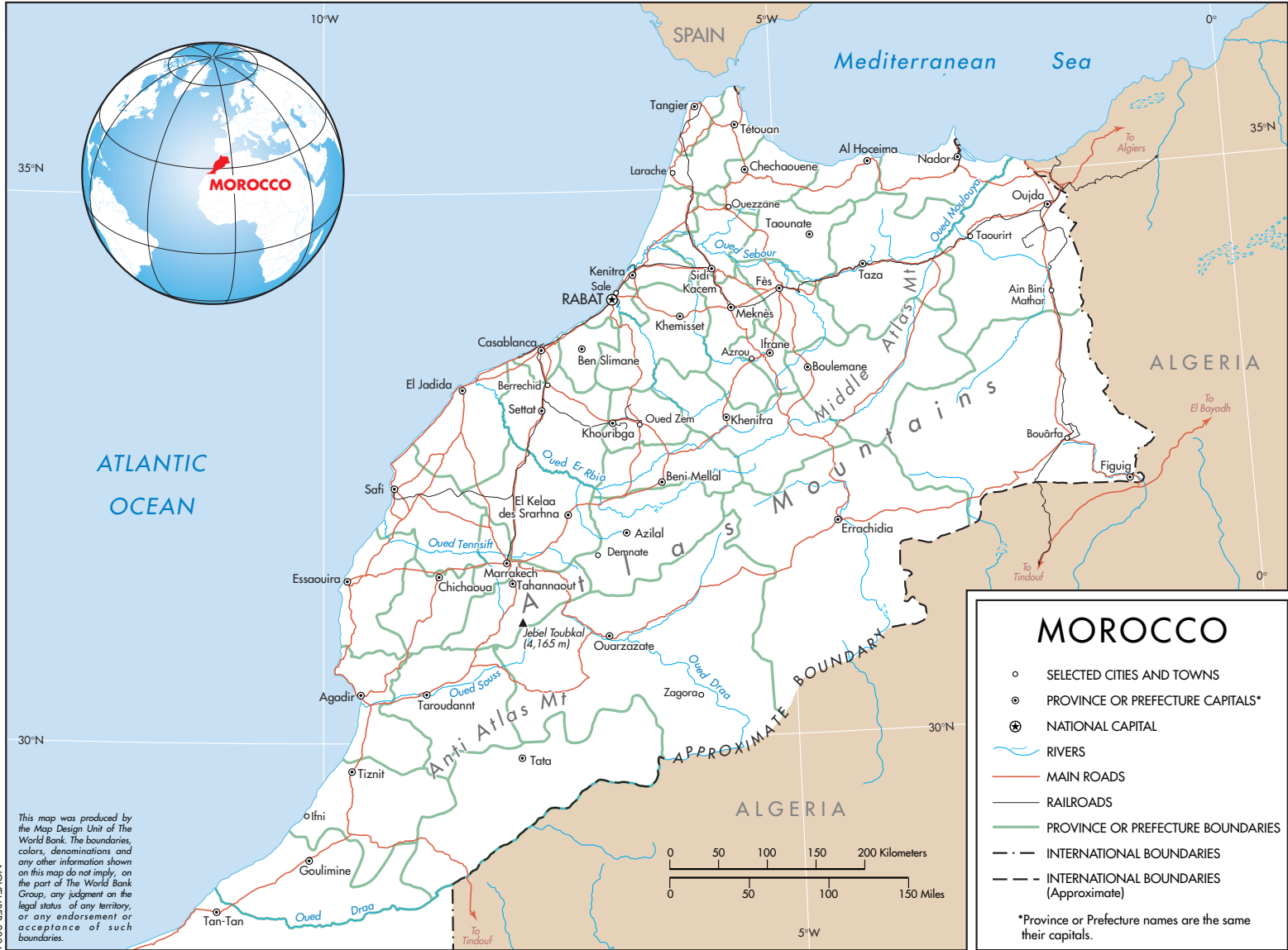
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- RIVERS
- MAIN ROADS
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This book identifies the binding constraints to growth of Morocco. It applies an innovative procedure known as "growth diagnostic" and has a central finding. The Moroccan economy suffers from a too slow process of structural transformation for achieving higher growth, especially for its exports that face unfavorable external shocks arising from competitor countries in the main markets for Moroccan exports. This process of so-called "productive diversification" requires that Morocco enhance its competitiveness.

Four government failures are identified as the binding constraints to growth of Morocco: 1) a rigid labor market; 2) a taxation regime that represents a heavy burden for firms and an obstacle to hiring skilled human capital; 3) a fixed exchange rate regime that has allowed regaining price stability, but, given existing rigidities in the labor market, does not favor international competitiveness; and 4) an anti-export bias, featuring a still high level of trade protectionism despite recent progress in tariff reductions and the signing of several Free Trade Agreements (FTA). In parallel, three market failures affect competitiveness and innovation: information failures, coordination failures between the public and private sector, and training failures that rank the country among those with the lowest level of training offered by businesses.

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THE WORLD BANK
1818 H Street, NW
Washington, DC 20433 USA
Telephone: 202 473-1000
Internet: www.worldbank.org
E-mail: feedback@worldbank.org

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