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Priorities for Rapid & Shared Economic Growth in Egypt

Policy Viewpoint is devoted to the discussion of ideas and policy options for enhancing economic development in Egypt. The series is based on research conducted by ECES. The content and recommendations are endorsed by the Center's Board of Directors.

Most economists and policy makers agree that no other economic objective deserves more emphasis than rapid and shared economic growth. By growing rapidly and distributing the benefits widely, society can create jobs, provide social services, and maintain political stability. The issue, however, is: What are the reform priorities to pursue this objective?

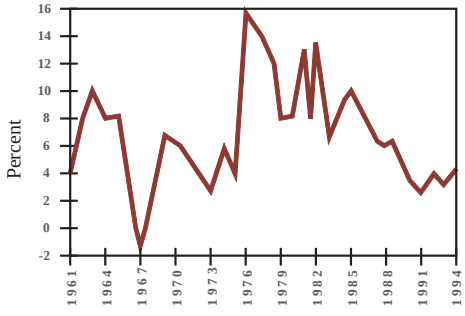
This *Policy Viewpoint* shows that the pay-off to the Egyptian economy is greatest if effort is focused on reforming the education system, reducing the size of government, promoting savings and investment, and improving the rule of law, in that order. Additional gains can be expected from opening up the economy. These conclusions are based on answering two questions: What does it generally take to grow fast? And, how does Egypt compare with the fast-growing economies?

What does it generally take to grow fast?

Economists believe that growth can only come from factor accumulation (physical and human), efficient allocation of resources and productivity. What is less well known is that it is the combination of these sources of growth that makes a difference. The accumulation of investment in machines and human capital does not suffice. Nor does the efficient allocation of resources or productivity.

Three examples illustrate this point. First, the former Soviet Union and other Eastern European countries were able to invest and grow fast for decades. Yet, the system eventually collapsed in the 1980s. Why? There was too much emphasis on the accumulation of physical and human capital, and too little emphasis on the efficient allocation of resources and productivity. The system provided distorted prices and failed to motivate managers and workers to improve productivity. The same point can be made with respect to Egypt in the period 1975 - 1985. During this period, investment and GDP grew fast (Figure 1), aided by favorable

Figure 1. Real GDP Growth in Egypt, 1961-94

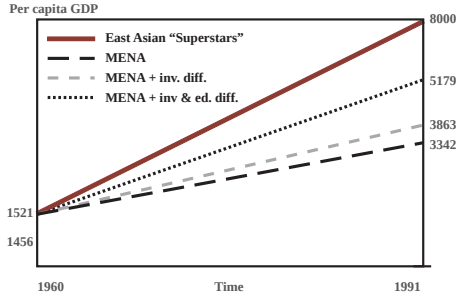


Source: Calculated from IMF, IFS, different

oil prices, high remittances of workers and access to foreign loans. However, distortion of prices was pervasive and the domination of state-owned enterprises meant that economic agents had limited incentives to increase productivity.

In contrast, East Asian countries -- despite their current short-term crisis -- were able to grow fast for an extended period of time because they accumulated substantial physical and human capital, provided appropriate prices, and linked compensation to performance. In this context, it is noteworthy that more than 50 percent of the difference in per capita growth rate between East Asian countries (including Korea, Taiwan, Hong Kong, Singapore, Indonesia, Malaysia and Thailand) and a sample of Middle Eastern countries (including Morocco, Algeria, Tunisia, Egypt, Jordan, Syria, Iran and Iraq) is attributed to differences in productivity (Figure 2).

Figure 2. Sources of Differences in Per Capita Growth Between East Asia and MENA



Source: John Page (1996).

What determines the fast accumulation of capital, efficient resource allocation and productivity? Economists have for long tried to answer this question, and their thinking has evolved over time. According to the most recent literature concerned with accounting for growth, the factors leading to fast economic growth are of two types: basic conditions and choice variables (see columns 1 and 2 of Table 1 for a list of the most frequently used variables and their relationship to growth).

Under basic conditions, the most critical variables are the initial level of per capita income and investment in human capital. Growth is higher in countries of lower initial per capita income because these countries tend to have less capital per worker and, therefore, offer higher rates of return on investment, which translates into higher growth rates. Growth is also higher the greater

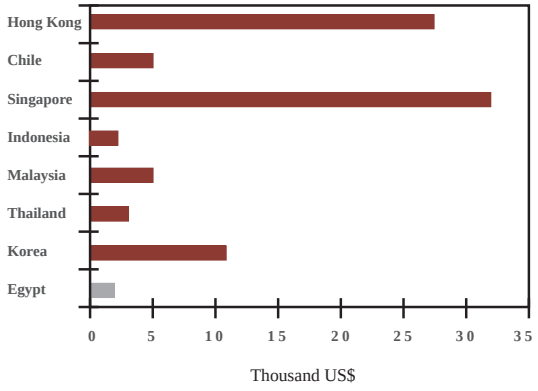
the investment in human capital because an educated labor force can use technology more efficiently. Related to the same variable is that a more egalitarian education system helps growth because it produces good citizens, thus better governance and policies and less instability.

Among the choice variables, the most important are savings/investment, size of government, openness, macroeconomic stability and protection of property rights. Higher savings correlates positively with growth because it makes funds available for investment. Smaller government contributes to growth because it means less non-productive spending and lower taxes, freeing more resources for the private sector to save and invest. More open economies grow faster because lower tariffs and other trade barriers reduce distortions in domestic markets and increase competition. Macroeconomic stability is associated with lower inflation, which reduces uncertainty and encourages investment. Finally, investors care about the effectiveness of law enforcement, when choosing to invest.

How does Egypt compare with the fast-growing economies?
Compared with a number of fast-growing economies, Egypt does well on some determinants of growth but not as well on others. Per capita income in Egypt is relatively low, which means that there is room for improvement (Figure 3). Egypt has also achieved macroeconomic stability and curbed inflation to levels comparable to the fast-growing economies. Egypt, however, lags behind on several accounts, the most important of which is education (measured by the average years of school completed) and education quality (measured by the standard deviation of the average year of schooling, see Figure 4 and 5). Although the government invests 6 percent of GDP on education, the return on this investment has been low due to a legacy of vast illiteracy, skewed expenditure on higher education, and high drop-out rates.

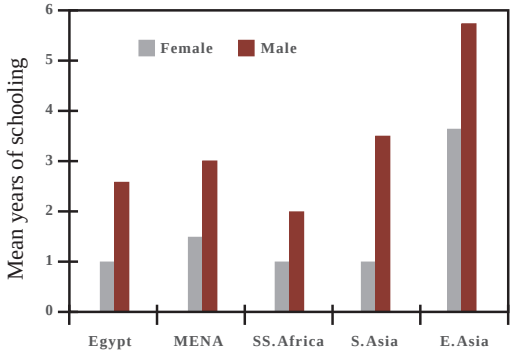
Egypt also lags behind in domestic savings, the size of government, the degree of openness to the rest of the world, and investors' perception of property rights protection. Domestic savings relative to GDP is only 18 percent, compared with over 30 percent in the fast-growing economies (Figure 6). The share of government expenditure relative to GDP is still high (Figure 7). Tariffs on imports are also high (Figure 8) and the perception of investors, measured by an index of their willingness to accept established institutions to make and implement laws and adjudicate disputes (Figure 9), ranks low for Egypt. The extent to which Egypt deviates from the average for fast-growing economies on each variable is given in column 3 of Table 1. The magnitude of deviations suggests that significant reforms are needed to put Egypt on a path of rapid economic growth. The question is: Where to start?

Figure 3. Per Capita GDP in Egypt and Selected Fast-growing Economies, 1996



Source: The Global Competitiveness Report, 1997.

Figure 4. Human Capital Accumulation



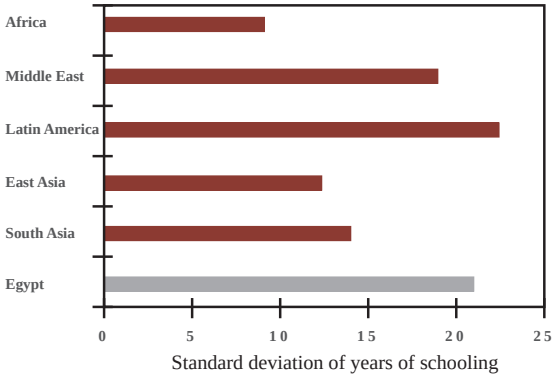
Source: Nemat Shafik (1996).

Table 1. Factors Explaining Growth

Variables	Relation to growth	Deviation from the avg. of fast-growing economies	Regression coefficient	Predicted growth (%)
Initial conditions				
Per capita GDP	Negative	--	-0.026	--
Human capital *(average years of schooling)*	Positive	-0.90	0.012	1.06
Choice variables				
Investment *(% of GDP)*	Positive	-17.95	0.043	0.77
Size of government *(Gov. expenditure % of GDP)*	Negative	6.80	-0.136	0.93
Openness *(average tariff rates)*	Positive	14.91	-0.018	0.26
Macroeconomic stability *(inflation rate)*	Negative	1.92	-0.043	0.08
Rule of law	Positive	1.50	0.004	0.63

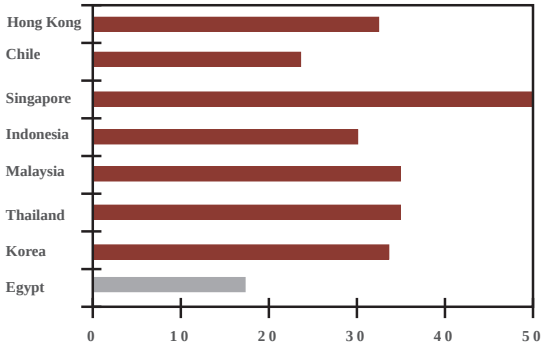
Source: Robert J. Barro (1997); Robert J. Barro and Xavier Sala-I-Martin (1995); and author's calculations.

Figure 5. Human Capital Inequality



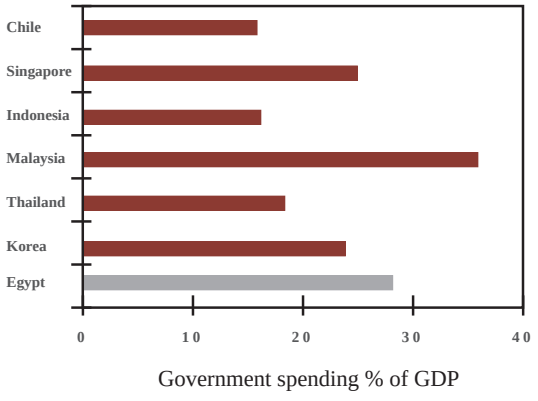
Source: Nancy Birdsall (1997).

Figure 6. Savings in Egypt and Selected Fast-growing Economies, 1996



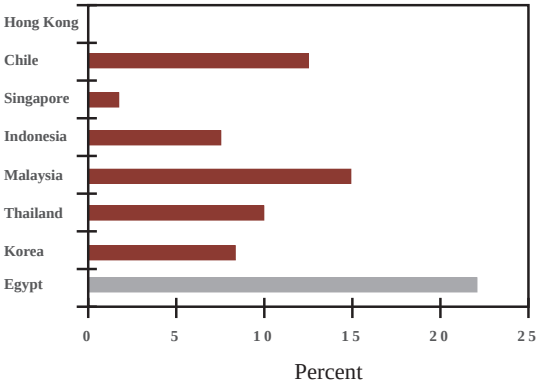
Source: The Global Competitiveness Report, 1997.

Figure 7. Size of Government in Egypt and Selected Fast-growing Economies, 1996.



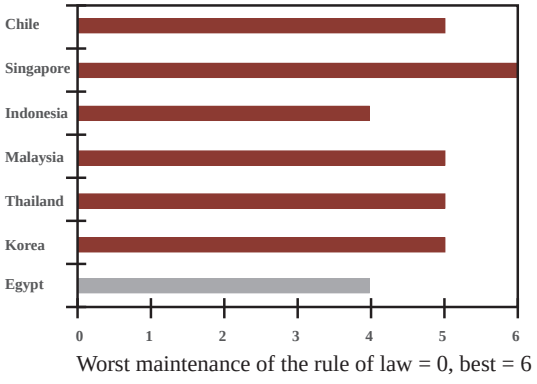
Source: The Global Competitiveness Report, 1997.

Figure 8. Average Tariff Rates, 1996



Source: The Global Competitiveness Report, 1997.

Figure 9. Rule of Law Index, 1995



Source: International Country Risk Guide.

Priorities for faster economic growth

Policy makers cannot tackle all problems simultaneously. If they were to allocate their political capital to reforms with the highest return in terms of potential growth, then their focus should be on education, reducing the size of government, promoting savings and investment, improving the perception of property rights protection and opening up the economy, in that order (column 5 of Table 1 gives an order of magnitude of the additional gains in growth units resulting from reforms in each of these areas). If successful, Egypt could increase per capita income by as much as 3.7 percent and exceed the desired target of 7 percent.

To bridge the policy and institutional gap between Egypt and the fast-growing economies, the following key reforms are necessary.

• *Education*. While government expenditure on education is not low, it is biased in favor of higher education. A shift in expenditure to basic education has been shown to generate more returns to society. Along the same lines, it has also been shown that the social return on educating girls is the best investment government can make. Accordingly, it may

be socially desirable to subsidize the education of girls. Finally, even if the government continues to finance education, the experiences of other countries suggest that private sector participation in the delivery of education services, adopting performance-based incentives for teachers, and encouraging the participation of parents in monitoring schools help improve the education system.

• *Size of government.* Although the size of government expenditure relative to GDP has declined over time, it remains over 30 percent compared with about 20 percent in the fast-growing economies. Reducing the size of government requires lowering tax rates and curtailing investment which the private sector could undertake more efficiently. Besides the level of government expenditure, a review of this pattern is necessary to ensure greater complementarity to private sector investment and better targeting to the most needy.

• *Savings/investment.* Greater domestic private savings is generally believed to follow growth. However, it may be possible to stimulate savings by reforming the pension system such that pensioners see a strong link between their contribution and benefits, as in Chile. Privatization is another channel, which has been shown to have the potential to increase savings by as much as 2 percentage points of GDP (Galal, 1996) from selling one-third of SOEs in Egypt, because privatization is associated with improved productivity and the mobilization of foreign savings. Finally, deepening financial sector reform could promote savings and help channel these funds into efficient uses. Ensuring that the generated savings are translated into investment requires a stable macroeconomic environment, low transaction costs, high policy credibility and a supporting infrastructure. These preconditions are required for both domestic and foreign investment.

• *Protection of property rights*. Protecting the right to exchange, use and reap the benefits of assets is key to faster growth. This involves providing stable and transparent rules of game, enforcing them efficiently, and settling disputes fairly and expenditiously. But these reforms are too general and cover a wide range of issues. One place to start is by relying on what the private sector considers to be the most binding constraint. In this regard, a recent survey of 150 firms shows that the most binding institutional constraints relate to tax administration and conflict resolution mechanisms (Fawzy and Galal, forthcoming).

• *Openness*. Opening up the economy to the rest of the world involves lowering tariff rates gradually and moving to a more flexible exchange rate system.[1] Both measures reduce the bias against exports, expand labor-intensive industries, and thereby improve income distribution. To further reduce the bias against exports, it is necessary to liberalize services (telecom, power, transport, ports and banking). It is estimated that the inefficiency of services is currently taxing exporters by as much as 15 percent. Finally, while pursuing liberalization through integration with the major trading partners, the objective should be to open up the economy multilaterally to avoid trade and investment diversion.

This list of priority actions may seem long and difficult to implement. But Egypt of the 1990s appears to be up to the task. With a concerted effort on the part of government, private sector, donors and research institutes, the goal is within reach.

[1] Once inflation is reduced, the merit of using the exchange rate as a nominal anchor of reform could reduce the competitiveness of exports and encourage consumption by increasing imports, and thereby lower domestic savings, investment and growth.

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