



**Investment Policies and the Unemployment  
Problem in Egypt**

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## **Abstract**

Since the early 1990s, Egypt has experienced rapid and substantial aggravation of the unemployment problem. And despite consensus about the adverse economic, social and political implications of this problem, the present study starts from the premise that the real danger of unemployment lies in the fact that it reflects low and inefficient levels of investment and growth. Accordingly, this paper attempts to analyze the relation between the levels and patterns of investment and unemployment in Egypt. The ultimate objective is to reach a set of policies that could enhance the levels and efficiency of investments to achieve labor-intensive growth.

The analysis shows that the increase in the level of unemployment has been primarily due to the inability of economic policies in general and investment policies in particular to achieve high and labor-intensive growth rates. These policies led to modest investment levels, which weakened the economy's ability to create jobs, and resulted in investment patterns biased against labor-intensive growth.

The paper concludes that a diligent approach to handling this problem requires a review of development and investment policies. In this respect, it offers two sets of suggestions. The first deals with the investment policies needed to achieve high and sustainable rates of investment and growth. These policies include macroeconomic measures and policies to improve the investment climate. The second set of suggestions deals with investment incentives and the relative price structure to achieve labor-intensive growth.

## **I. Introduction**

Without delving into the current controversy regarding the size of unemployment in Egypt, it could be said that unemployment has become a living reality in Egypt today. It is also one of the most serious problems preoccupying those concerned with Egypt's development. Media, written or visual, continuously feature unemployment as a topic of debate. Hardly any intellectual discussion is free of a reference to this phenomenon and its social and political repercussions. In fact, dealing with the unemployment problem has come to be viewed as the true measure of success for Egypt's economic reform efforts.

There is general agreement that the seriousness of this problem is due to its economic, social, and political implications. Unemployment also leads to numerous adverse consequences, such as wasting human resources, aggravating poverty, and violating human rights. It could also increase social tensions, and negatively affect political stability. This study, however, begins from the premises that the real danger of the unemployment phenomenon lies in the fact that it is a reflection of the qualitative and quantitative deterioration of development rates and the low level and inefficient distribution of investments.

The paper stresses that serious and effective handling of the unemployment problem will not be possible through partial or expedient solutions, but requires a review of the prevailing development pattern as far as the level of investment and its distribution structure are concerned. The case for reconsidering the current investment policies is compelling. However, this does not mean to underestimate efforts aimed at curbing population growth, raising the education level, and improving labor market mechanisms. These efforts, despite their significance, are not sufficient as they concentrate on the supply-side only. The bottom line of this study is that the unemployment problem cannot be appropriately discussed in isolation from investment policies. By investment policies, we mean those policies that affect the investment decision and pattern with regard to the nature of the economic activity, the type of production method, the size of the enterprise, and lastly, whether production targets the domestic or export markets. In other words, policies that

determine the level and pattern of investment. Thus, they include policies that affect the investment climate such as taxes, port services, domestic transportation, litigation procedures, transaction costs, and the predictability and transparency of economic policies. Further, they include incentives, broadly defined, which involve exemptions and privileges, the relative cost of labor and capital, as well as the relative prices of goods in the domestic and international markets.

This paper attempts to analyze the relationship between investment policies and the unemployment problem in Egypt. The objective is to reach a package of policies that will help raise the level and efficiency of investment in order to achieve high rates of labor-intensive growth. In particular, the study concentrates on analyzing this relationship during the 1990s. However, the analysis will in some cases extend beyond the 1990s due to the fact that the volume of investment today is but a result of past investment decisions, and also due to the deep roots of the unemployment problem.

To achieve the objective of the study, the paper first reviews the relationship between investment and unemployment in light of economic theory and practical experience, with the purpose of providing an appropriate analytical framework for discussing the relationship between investment and unemployment in Egypt. Section II analyzes the nature of this relationship in Egypt to determine whether the current level and pattern of investment contribute to aggravating the unemployment problem. Section III examines investment policies and incentives that may be responsible for the limited contribution of investment in generating job opportunities. The conclusion will offer a set of investment policy proposals aimed at boosting labor-intensive growth in Egypt.

## **II. Theoretical Framework and Practical Experience**

Before studying and analyzing the relationship between investment and unemployment in Egypt, it might be useful to test this relationship in light of the economic literature available in this respect. A review of this literature will show that despite the numerous economic theories and the differences between the experiences

of countries and their levels of development, it is possible to gather some theoretical information and practical observations which will be presented below.

### ***Theoretical Framework***

Unemployment has been and continues to be one of the most important challenges facing the various economic systems. Therefore, it is not surprising that this problem has figured prominently in all schools and trends of economic thought. In this respect, it is possible to distinguish between a number of economic schools, the most important of which are the Classical, the Neo-classical, the Keynesian, the Monetary, and the Neo-liberal schools (El-Khawaga 1989; and Zaki 1997).

However, before reviewing the conclusions of these theories, it is important to draw attention to two points. The first is that despite the fact that these theories are more suitable to the economies of capitalist countries as opposed to those of developing ones, they provide an analytical framework for understanding the different dimensions of this phenomenon in developing countries, taking into account the different economic conditions. The second is that despite the differences among these schools of thought with regard to the diagnosis of the problem and appropriate remedies, they help in reaching some conclusions, most important of which are the following:

- There is a consensus that full employment is but a theoretical concept that cannot be realized even in the most advanced countries. This is due to the presence of a degree of ‘frictional unemployment’ ranging between 2-4 percent, even during the times of great boom.
- There is a consensus that the phenomenon of unemployment is attributed to the mismatch between labor supply and demand. More precisely, it is due to the fact that labor demand falls short of labor supply.
- Views on how to solve this problem vary. On one hand, the Classical school focuses on correcting supply-related issues, and particularly on the

functioning of the labor market. Under the assumption that the labor market is characterized by perfect competition, proponents of this theory believe that elasticity of wages will automatically lead to full employment. On the other hand, Keynes shows that the capitalist system does not possess the inherent mechanisms that drive it to equilibrium at the level of full employment. He also shows that wages are sticky downward and that the employment level is not determined by the intersection of the demand and supply curves in the labor market, but rather by the level of actual demand, from which labor demand is derived. In view of the above, Keynes proposes a solution to this problem through stimulating effective demand.

Despite the importance of the two previous approaches, as well as the fact that they complement each other, this paper chooses to adopt the Keynesian viewpoint which focuses on stimulating effective demand. It concentrates in particular on the role of investment policies in creating productive employment opportunities. And while unemployment is a complicated phenomenon caused by several factors, this paper largely attributes the problem in Egypt to the low quality and volume of investments to effectively contribute to achieving high levels of employment. The paper has adopted this approach because most of the studies concerned with solving the unemployment problem worldwide have generally attributed widespread unemployment to the inadequacy of aggregate demand (World Bank 1995). In addition, most studies concerned with the unemployment problem in Egypt have focused on supply-related solutions (Assaad 1997; Radwan 1997; and Al- Ahwany 2001). While supply-related solutions are usually long-term, the investment policies concerned with activating demand show their effects in the short and medium terms. Practical experience has also proven their effectiveness (Griffen 1996).

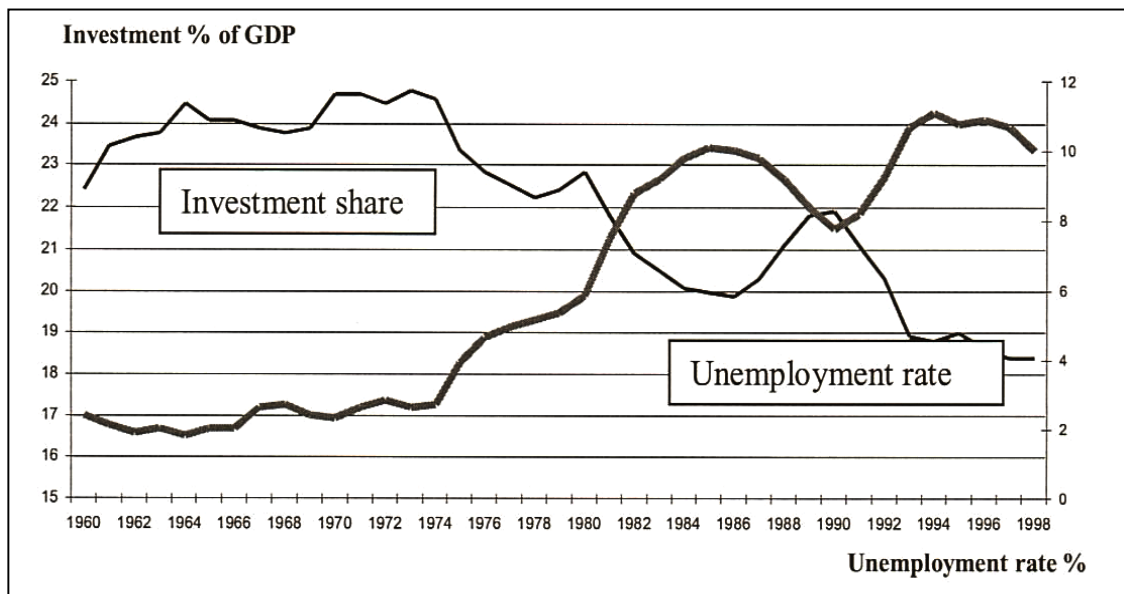
### ***Practical Observations***

The experiences of developed and developing economies point to some observations which support the existence of a relationship between the level and pattern of

investment on one hand, and the unemployment level on the other. The following is a brief review of practical experience regarding this relationship.

- Examining both the ratio of investment to the gross domestic product and the unemployment rate in the European Union during the years extending between 1960-1998, indicates a continued inverse relationship between the investment rate and unemployment. While admitting that there are other factors that may affect these two variables, it could be concluded that increasing the investment rate plays an important role in decreasing the unemployment rate (Figure 1).

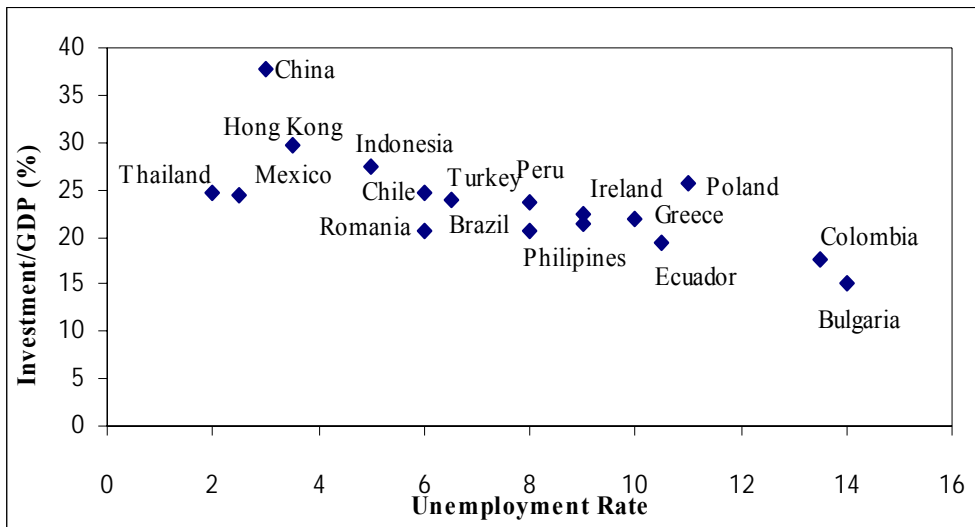
**Figure (1): Investment and Unemployment Levels in the European Union**



*Source:* EU (2000), “Community Policies in Support of Employment,” ([www.europa.eu.int](http://www.europa.eu.int), 25/12/2000).

- This relationship is present in many developing countries, as seen in Figure (2), which shows that the higher the investment rate to GDP, the lower the rate of unemployment.

**Figure (2): Investment and Unemployment Levels in a Selected Group of Developing Countries**

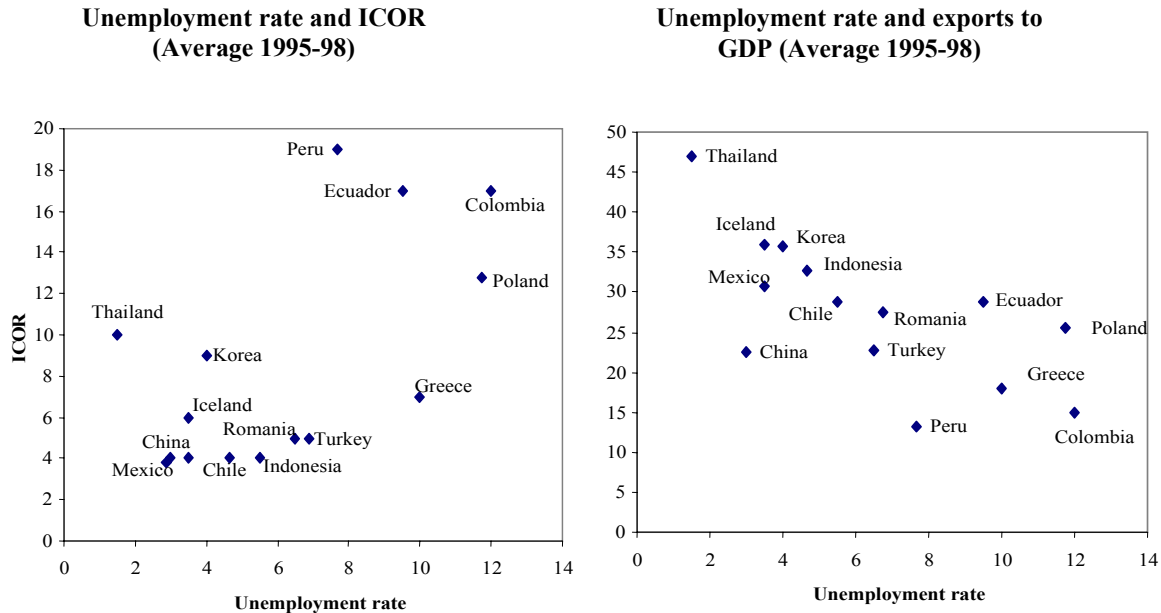


*Source:* World Bank (2001), World Development Indicators, CD-ROM.

- The experiences of many developing countries indicate that the unemployment rate tends to decrease with the presence of export-oriented investment patterns, with the use of labor-intensive technologies, and lastly, with the growth of small enterprises. Figure (3a) shows that the higher the capital intensity (measured by the marginal capital/output ratio), the higher the unemployment rate. Figure (3b) shows that the unemployment level tends to decrease with higher exports in relation to GDP.



**Figure (3): Investment and Unemployment Patterns in a Selected Group of Developing Countries**



*Source:* World Bank (2001), World Development Indicators, CD-ROM.

In light of the theoretical framework and practical experience reviewed, it can be said that the unemployment rate is affected by both the level and pattern of investment. In other words, the unemployment problem can be alleviated when the level of investment is high and the pattern of investments encourage labor-intensive production techniques, export-oriented activities, and small enterprises. The pressing question is “what about the relationship between investment and unemployment in Egypt?” The following section intends to answer this question.

### III. Investment and the Unemployment Problem in Egypt

Although the Egyptian economy experienced a quantitative and qualitative increase in unemployment during the late 1990s, the roots of this problem go back a relatively long time. Therefore, it might be useful to start this section with a quick review of these roots since the 1960s, to be followed by a more detailed study of the relationship between investment and unemployment in Egypt during the 1990s. From

this review, it is possible to distinguish among three different phases of unemployment (Radwan 1997).

The first phase, which covers the 1960s, was in a sense known as the full employment period since open unemployment did not exceed 2-3 percent. The low unemployment rate at the time could be explained by huge government investments in infrastructure, agriculture, import substitution industries, and the increasing role of the state in economic activity. The state was the main economic player and the main entity responsible for employment through its policy of guaranteed recruitment for all graduates.

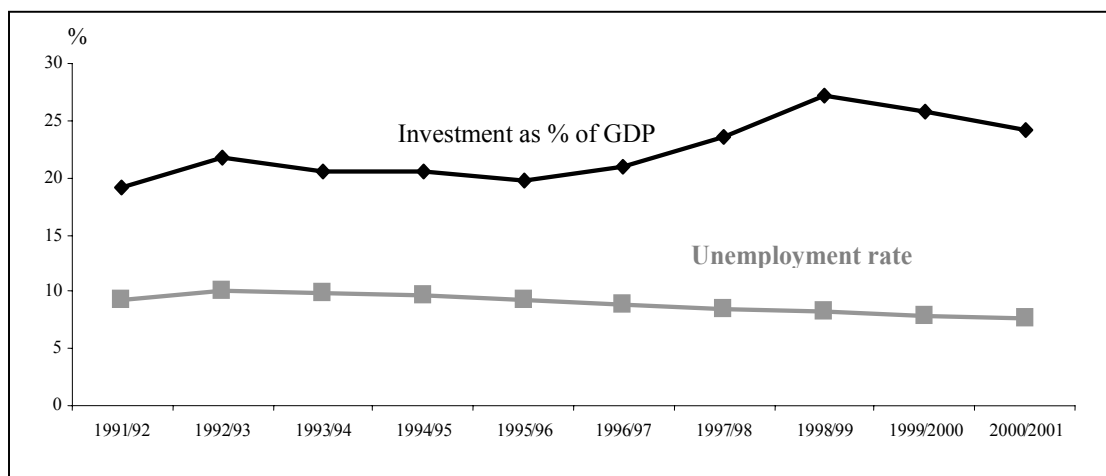
The second phase started in the mid-1970s and continued until the mid-1980s. During this period, the problem of open unemployment began to emerge, although at modest and unalarming rates. On one hand, the emergence of this problem could be explained by the fact that the traditional mechanisms for absorbing the increasing numbers of the labor force - through agriculture and government employment - had started to reach saturation. On the other hand, the low rates of unemployment could have been due to the high growth rates resulting from the open door policy, the increase in foreign capital inflows during that period, the growth of the informal sector, and lastly, the increasing demand for Egyptian labor in the Gulf states as a result of the increase in oil prices.

The third phase started in the mid-1980s and continues to date. During this period, the unemployment problem increased gradually in magnitude; and became more severe over time, reaching high levels during the late 1990s. As a result, this problem became top priority on the government agenda, although official data do not reflect this fact. This topic will be discussed in more detail later in this paper.

To identify the nature of the relationship between investment and unemployment in Egypt, and by referring to Figure (4) which shows the development of these two variables during the past 40 years, we could say there is an inverse relationship between the investment level and unemployment. However, the nature of this relationship in Egypt is not as clear as in the case of the European Union and some of the developing countries (Figures 1 and 2). This may

be due to inaccurate data, the government employment policy, the growth of the informal sector, and lastly, the prevailing pattern of investment in Egypt.

**Figure (4): Development of Investment and Unemployment in Egypt**



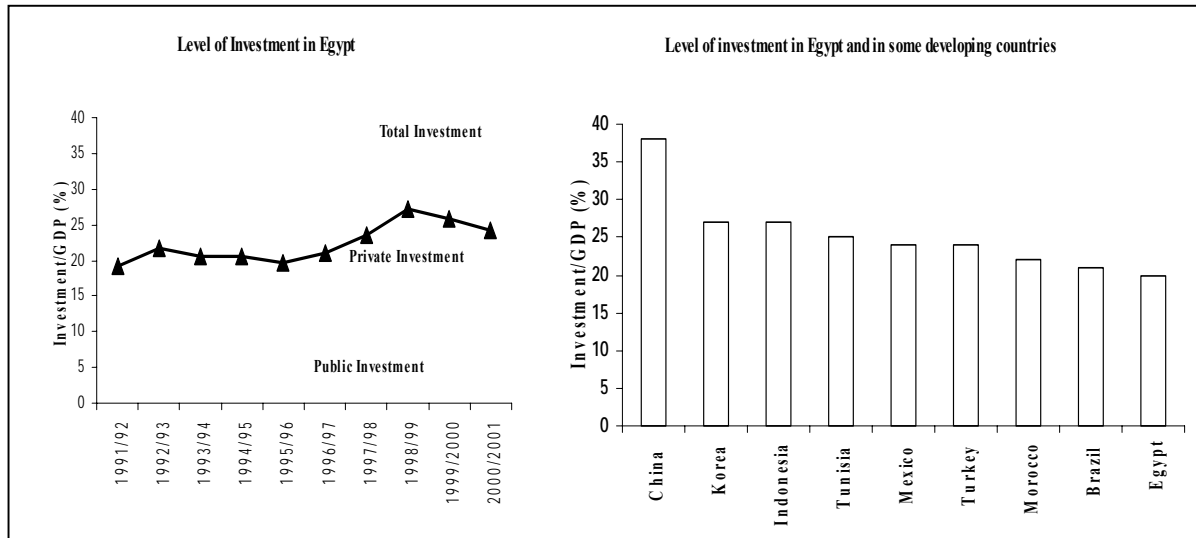
*Source:* Central Bank of Egypt, Economic Review, several issues.

In the following sub-section, we will try to explain to what extent the level and pattern of investment contributed to the increase of unemployment during the 1990s.

### ***Investment Level***

By reviewing investment rates in Egypt during the 1990s as shown in Figure (5), we notice that the average investment to GDP is lower in Egypt than in many of the developing countries in the Middle East, Latin America and finally in East Asia (during the period 1992-1999). We also notice that this rate tended to decrease starting in 1998/1999 until 2000/2001. This downward trend is explained by the inability of private investments, despite their increase, to make up for the decrease in public investment. This led to a fall in total investments during the later part of this period.

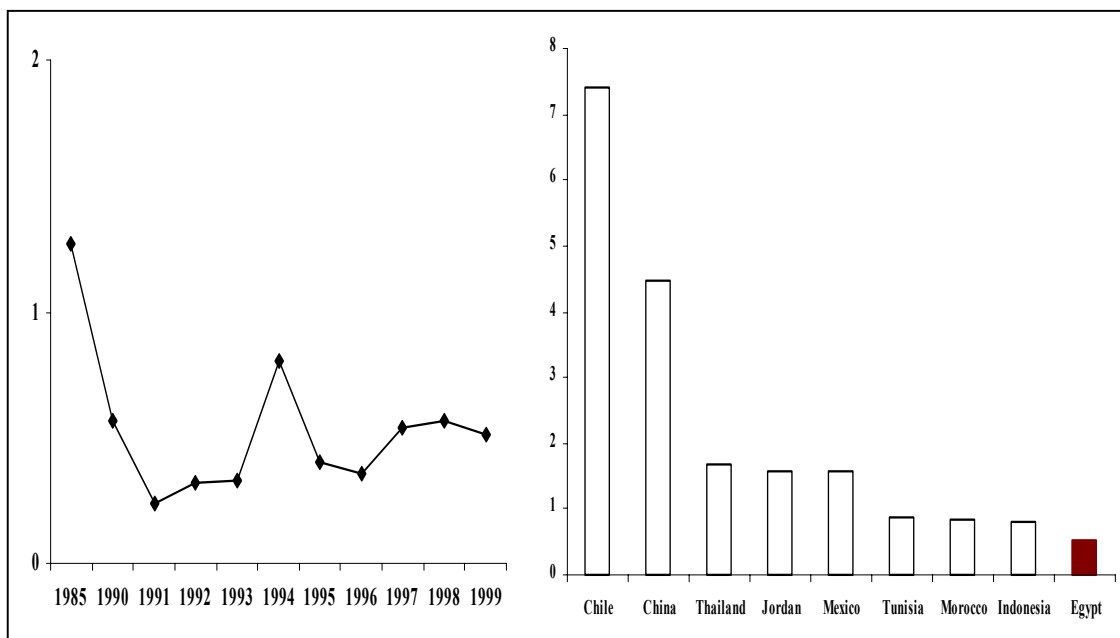
**Figure (5): Investment Level in Egypt**



*Source:* World Bank (2001), World Development Indicators, CD-ROM and Central Bank of Egypt, Economic Review, several issues.

On the other hand, Figure (6) shows limited foreign direct investment (FDI) flows to Egypt during the 1990s, whether as a percentage of GDP or compared to the same ratios in the previously mentioned developing countries.

**Figure (6): Level of Foreign Direct Investment in Egypt**



*Source:* World Bank (2001), World Development Indicators, CD-ROM.

Before analyzing the relationship between investment and unemployment during the 1990s, two fundamental remarks are noteworthy. The first is related to investment rates, which tended to increase during the period 1993-1997, though they are still lower than those in similar developing countries (Figure 5). In addition, the period 1998-2001 witnessed a considerable deterioration in these rates. The second remark is related to actual unemployment rates, which during the last three years have become much higher than the officially declared rates (Figure 4). Strong evidence leads us to believe that the declared unemployment rates, ranging between 8-9 percent during these three years according to the Central Agency for Public Mobilization and Statistics (CAPMAS) in 2001, are biased downward. This is evidenced by the following observations:

- Some applied studies estimated the unemployment rate in Egypt at 15-17.5 percent (Fergany 1999).
- Accumulated unemployment increased from 1.4 million in the early 1990s to between 1.5- 2 million in 2000 (IDSC 2000).
- The annual number of new entrants to the labor market increased from 600,000 in 1992/1993 to 900,000 in 2000 (IDSC 2000).
- About 4.4 million applied for the employment programs announced by the government in 2001.
- The economy began to experience new sources of unemployment such as those incurred by the process of economic transformation in Egypt during the 1990s, and the cyclical unemployment the Egyptian economy witnessed in 1997, marking the beginning of a recession that became more intense after the September 11 events. In a recent study (World Bank 2001), cyclical unemployment due to the impact of September 11 on the tourism sector was estimated at 387,000 unemployed.<sup>1</sup>

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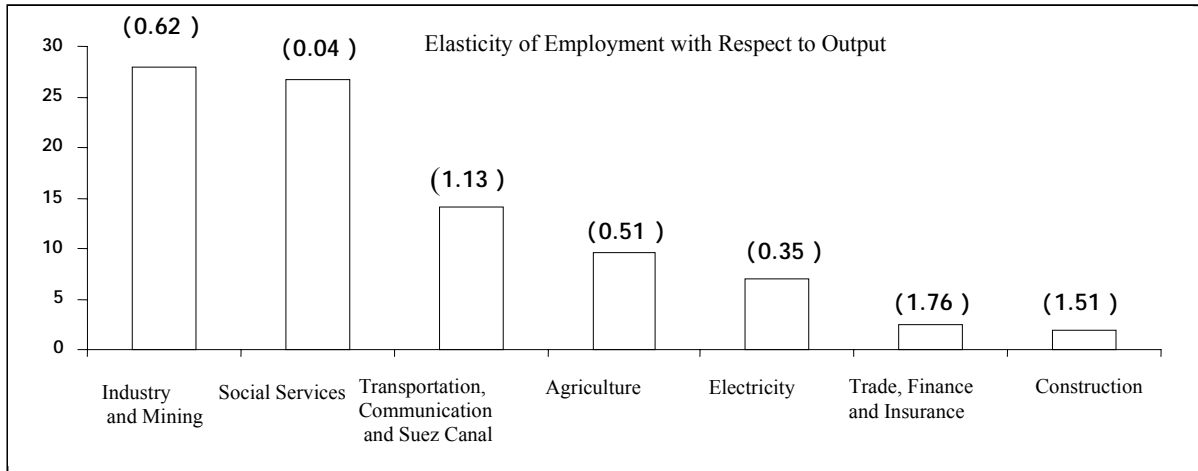
<sup>1</sup> The analysis of the characteristics of the unemployed increases the gravity of the problem. According to (Fergany 1999); (Assad 1997); and (Radwan 1997), unemployment reaches its peak in the age group 15-25 and that 95 percent of the unemployed have never worked before and are looking for their first jobs. This phenomenon is especially high among the educated - particularly holders of intermediate degrees, higher intermediate degrees and lastly university graduates - and in particular among the females, and in the rural areas.

Admittedly, it is difficult to link the investment rate and unemployment without taking into account other factors that affect the nature of the relationship between these two variables. Such factors include, for example, the pattern of investment distribution among the different economic sectors, the intensity of capital used in production and the time lag between the investment decision and its effect on creating employment opportunities. Bearing the above in mind, it is safe to say that the low average investment levels in Egypt compared to some developing countries during the 1990s and their downward trend during the last few years (Figure 5) may have been responsible, at least in part, for aggravating the unemployment problem as revealed by the living reality and not by the official data.

### ***Investment Pattern***

We will now attempt to determine to what extent the prevailing investment pattern has contributed to increasing the unemployment levels in Egypt. The investment pattern will be discussed from the following aspects: investment distribution among economic sectors; investment and the production technique applied; whether investment is oriented toward the domestic or international market; and finally, with respect to the size of the production unit selected.

An analysis of the current investment pattern in Egypt shows that this pattern has limited the ability of the economy to absorb the increasing number of workers. Figure (7) shows that the sectoral distribution of investments is inconsistent with the economic sectors' employment-generation abilities. On one side, there is a trend to concentrate investments in economic sectors characterized by their weak ability to absorb labor, or those with low elasticity of employment to output such as industry and mining, and social services sectors. On the other side, the activities characterized by a high elasticity of employment to output, such as construction, trade, finance, insurance, transportation and communications, have received a limited share of total investments.

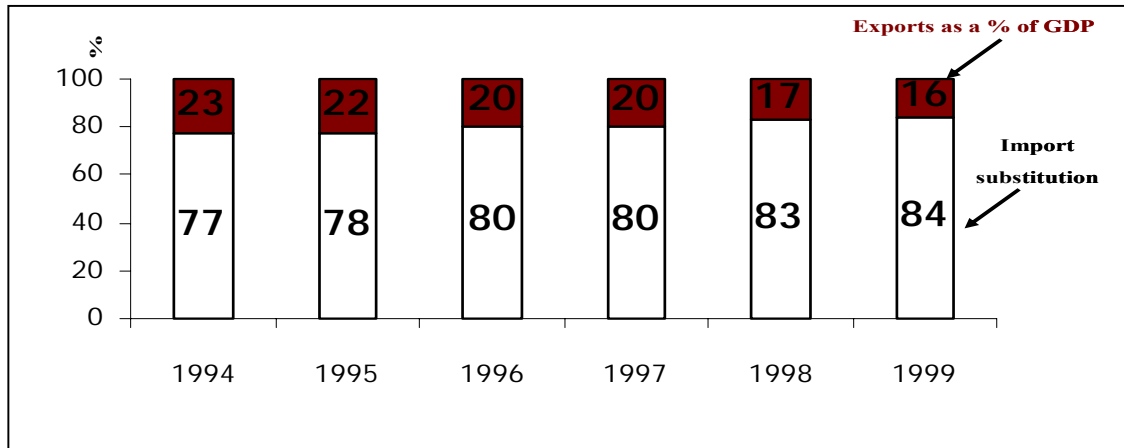
**Figure (7): Investment Distribution Pattern Among Economic Sectors**

Source: Ministry of Planning (2000), Main Changes in National Economy.

It can also be noted that there is an increasing trend toward using capital-intensive production techniques. This is clearly evidenced by the increase in the average cost of creating one job opportunity at the national level, from about LE 60,000 during the 1980s to about LE 103,000 in the late 1990s (IDSC 2000). This led to a decrease in the average elasticity of employment to output at the national economy level from 8.0 to 5.0 during the same period (Fergany 1999). This indicates that the growth rate achieved during this period did not significantly contribute to alleviating the unemployment problem. In other words, growth was not labor-intensive.

A review of the investment distribution pattern between production targeting the domestic market and that targeting exports shows that there is a general trend in favor of the domestic market. Figure (8) shows a small percentage of export-oriented production, as the percentage of goods and services exported did not exceed 20 percent of GDP on average during the 1990s, and this percentage trended downward from 23 to 16 percent during that decade.

**Figure (8): Investment Distribution Pattern Between Exports and Production for the Domestic Market**



*Source:* World Bank (2001), World Development Indicators, CD-ROM.

Lastly, the investment distribution pattern between small and large enterprises reveals that although small enterprises are responsible for employing more than half of the labor force in the industrial sector (about 54 percent), their share of investment does not exceed 14 percent (World Bank 1994).

In light of the above analysis, we can conclude that the low investment level and its deterioration during the last few years, as well as the inefficiency of the investment allocation pattern have played a fundamental role in decreasing labor demand which, in turn, led to high unemployment rates. This does not mean denying the existence of other factors that may have contributed to the deterioration of the employment levels. The most important of these factors are the depletion of the traditional mechanisms that absorb the labor force, weak demand in Arab countries for imported work force, the mismatch between the output of the educational system and the needs of the labor market, the increase in the growth rate of the labor force compared with the rate of creating employment opportunities, and lastly, the rigidity and distortion of the labor market.

#### **IV. Policies that Prevent Investment from Effectively Contributing to Job Creation**

What are the reasons that could explain the investment behavior that is incompatible with the employment objective? To answer this question, we will go one step further



in our analysis to determine the investment policies responsible for the decrease in investment as well as the inconsistency of its distribution pattern with the objective of raising employment levels. The more accurate our diagnosis of these policies is, the more appropriate and effective our proposed remedies will be.

### ***Policies Responsible for the Low Investment Level***

The deterioration of the level of private investment in Egypt may be explained by two main sets of reasons. The first set is related to the nature of the economic reform program and the problems of its implementation in Egypt. The second involves problems that make the investment environment less attractive and adversely affect investors' efficiency and competitiveness.

#### *Problems related to the economic reform program*

Although the economic reform program that began in the early 1990s stressed the need to downsize the role of the government and increase the role of the private sector to become the engine of growth, the response of the private sector has been and continues to be limited as far as raising growth and employment rates, and integrating into the international market. The response is also limited when compared to that in countries that have had similar economic conditions (Figure 4).

The weak response of private investment can be explained by the contractionary nature of the economic stabilization component in the reform program, and the slow implementation of the component of structural reform. One cannot accept the interpretation of this behavioral pattern or this cautious response by the "Wait and See" phenomenon known in most economic reform experiences. Most of these experiences indicate that the waiting period usually ranges between 3-4 years as in Mexico, Chile and Bolivia.

Despite the success of Egypt's economic stabilization program in the first half of the 1990s in achieving monetary and financial stability, its contractionary nature has imposed limits on the possibility of increasing the rates of private investment. Thus, the increase in private investment, as previously mentioned, was unable to compensate for the decrease in public investment or create new employment

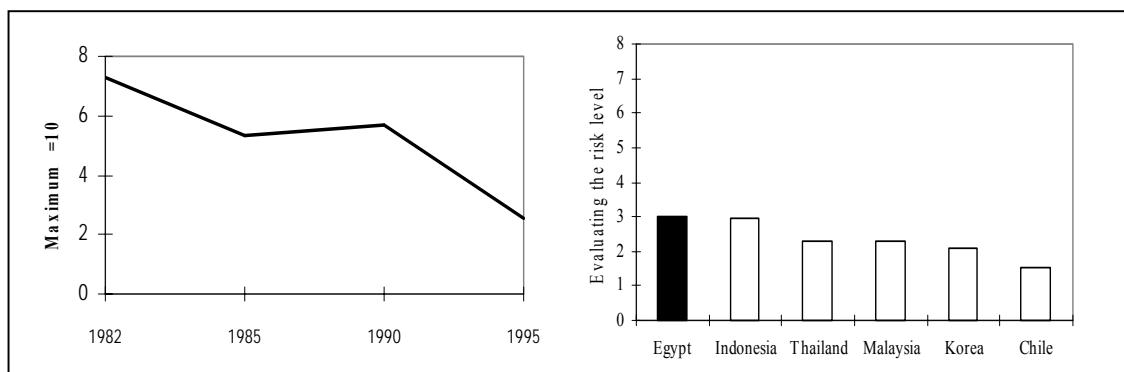
opportunities. This occurred at a time when the government partially and gradually abandoned its policy of employing the new entrants to the labor market. Moreover, the recession experienced by the Egyptian economy in the wake of the two external shocks in 1997 and 2001, led to the decrease in growth rates and to the postponement of investor decisions until economic conditions improve.

Alternatively, the structural reform component, labeled by Dr. Said Al Naggar as “The Greater Jihad” did not achieve an acceptable level of progress compared to “The Lesser Jihad” or the monetary and financial reform. By this we mean liberalization of foreign trade, raising the performance of the public sector, implementing the privatization program, improving the efficiency of the banking and financial sectors, improving the taxation regime, and institutional reform. These are all necessary preconditions for any economic policy aiming to encourage private investment to lead the growth and development process (Fawzy 1998).

*Problems related to the business environment*

A close review of the Egyptian economy reveals that the government exerted considerable efforts during the 1990s to remove the impediments facing private investment. These efforts led to the improvement of the business environment in Egypt. Yet, despite these positive steps, the ability of Egypt's business environment to attract investments - both domestic and foreign - is still weak compared with some of the competing countries (Figure 9).

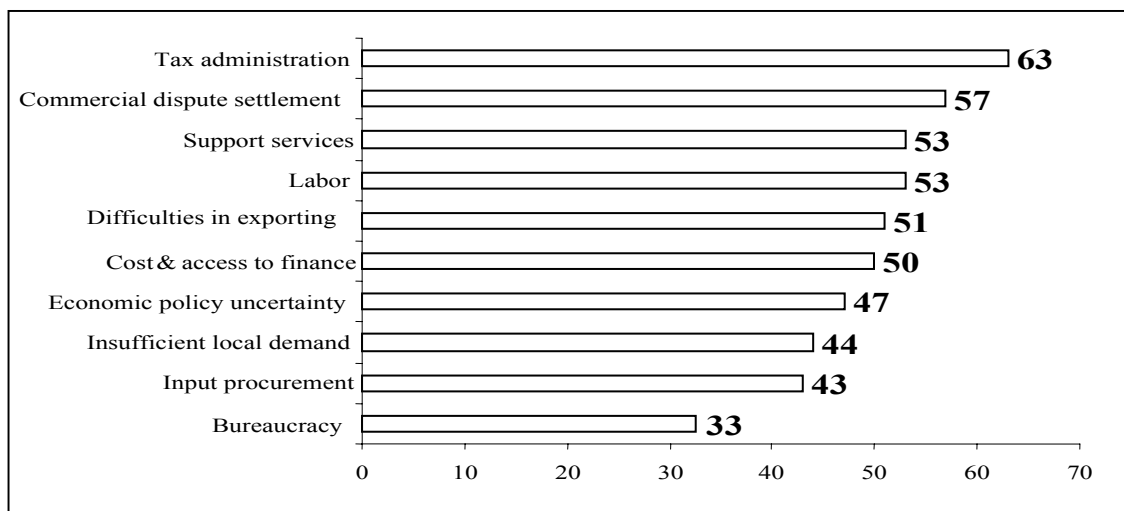
**Figure (9): Evaluating the Investment Climate in Egypt**



**Source:** Fawzy, Samiha (1998), “Business Environment in Egypt,” ECES Working Paper No. 34.

The results of a recent survey on private sector's views about the attractiveness of the business environment in Egypt reveal that there are still a number of restrictions and problems that limit private investment, and adversely affect its efficiency and competitiveness. According to the survey results (Figure 10), one can observe that the most significant obstacles impeding private investment are as follows: the complexity of tax administration, as investors indicated that dealing with the tax administration departments wastes time and effort which, according to them, translates into higher costs; inefficient and slow dispute settlement mechanisms, as the average time needed to settle any dispute in court is about 4.5 years; the absence or the inefficiency of support services such as training centers and laboratories that issue quality certificates and certificates of origin; the high cost of labor due to its low productivity and the high cost of social insurance; the difficulty of exporting due to the over-valued exchange rate at that time and the complicated procedures of custom rebate and drawback systems; the unavailability of a detailed database about foreign markets; the difficulty and high cost of obtaining financing; the lack of stability and clarity of economic policies; and lastly, the weak purchasing power in the domestic market.

**Figure (10): Problems Impeding Investment in Egypt**



*Source:* Fawzy, Samiha (1998), "Business Environment in Egypt," ECES Working Paper No. 34.

Although this survey dates back to 1998, most of the problems cited by investors still persist with a few positive and negative exceptions. On the positive side, investors' complaints about the over-valued exchange rate is no longer valid after the successive devaluations of the Egyptian Pound against the US Dollar from January 2001 until March 2002, which led to about 35 percent devaluation of the national currency. Yet, there are still complaints about the unavailability of foreign exchange in adequate amounts to finance the import of necessary inputs for the production cycle. On the negative side, some problems like the growing uncertainty about economic policies have become more acute. This came as a reaction to slow and inconsistent policies in handling what came to be termed as the recession or the economic slowdown. There is also the problem of the weak purchasing power in the domestic market in the wake of the recession that hit the Egyptian market in the late 1990s.

Overall, one could say that the recession in the early 1990s was due to the economic stabilization program, and in the late 1990s as a result of the 1997 and 2002 crises, the delay in the implementation of the structural reform program, and the continued suffering of investors from investment-related problems have all contributed to curbing the growth rate of private investment.

***Policies Responsible for Investment Patterns Inconsistent with the Employment Objective***

Now, we would like to turn to the reasons why current investment patterns have not tangibly contributed to alleviating the unemployment problem. In doing so, we analyze the investment policies and incentives responsible for the bias toward capital-intensive production techniques, and those that favor production for the domestic market rather than for export. We will also discuss the policies that prevent the growth of labor-intensive small enterprises.

*Reasons for the investment bias toward capital-intensive production techniques*

Investors' preference for capital-intensive production techniques could be attributed to the relative price structure of capital and labor that prevailed during the 1990s.

This price structure led to the decrease in the relative price of the former compared with the latter. The existence in the past of a negative interest rate, along with the overvalued exchange rate of the Egyptian Pound against the Dollar (estimated to range between 20- 30 percent during the 1990s), and the low customs tariffs on imported capital goods all led to a decrease in the relative price of capital. Conversely, the low nominal labor wages, the low productivity of labor, the stringent non-wage rules in the labor market (such as the difficulty to lay off labor during times of crisis, the complicated litigation procedures, the problems of hiring females, and lastly, the high cost of social insurance) have all led to a rise in the relative cost of labor. As a result, investment has tended to be biased toward using capital-intensive production techniques.

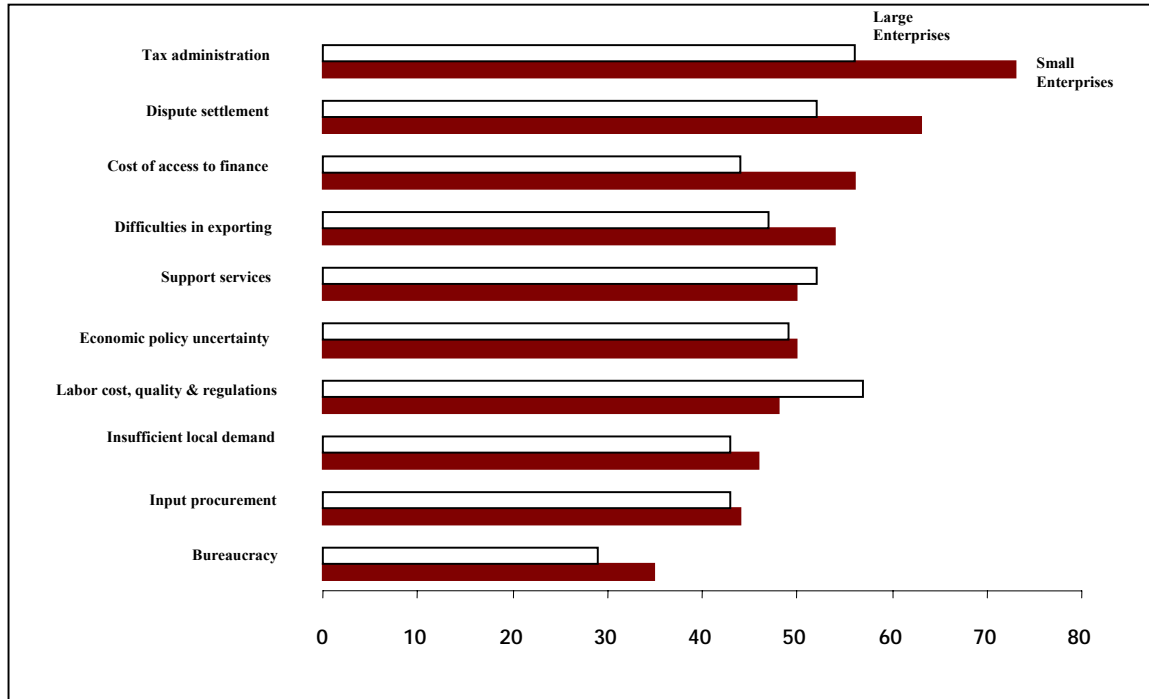
*Reasons for investment bias against export-oriented production*

The weak export performance in Egypt is due to the fact that investment incentives have led to distortion in the relationship between domestic and export markets, or between the prices of commodities in the domestic market and those in the international market. The high customs tariffs on final products, the over-valued exchange rate of the Egyptian Pound against the Dollar (before the latest devaluations), the complex customs rebate and drawback procedures for intermediate inputs - granted to exporters – all led to an investor preference to produce for the domestic market rather than for export markets. A recent study (Galal and Fawzy, 2001) shows that the profitability of producing for the domestic market ranges from 25-60 percent, while that of the producer exporting all his output does not exceed 19 percent. Another study by Kheir-El-Din et al. (Nathan Associates 1998) estimated the implicit tax on exporters at 19.8 percent due to the high customs tariffs.

*Reasons for bias against small enterprises*

Several studies (World Bank 1994; Fawzy 1998) indicate that small enterprises in Egypt suffer much more than large-scale enterprises from the shortcomings of the business environment. This is clearly observed in the problems related to taxes, dispute settlement, and obtaining financing. On the contrary, labor force problems are less evident in small enterprises compared with large ones (Figure 11).

**Figure (11): Intensity of Problems in Small and Large Enterprises**



*Source:* Fawzy, Samiha (1998), “Business Environment in Egypt,” ECES Working Paper No. 34.

In addition, small enterprises suffer from the bias of investment policies and incentives toward large enterprises. For example, many tax exemptions, like those granted to free zone-based enterprises and those granted to the joint-stock companies listed on the stock exchange, are only enjoyed by large enterprises. Furthermore, the exaggerated guarantees required to draw loans are a restriction on the ability of small enterprises to obtain adequate financing. In general, one may say that despite the numerous exemptions and incentives in the investment laws in Egypt, most of these laws hardly grant any incentives to small enterprises.

### **V. Toward Investment Policies that Help Achieve High and Labor-Intensive Growth**

The 1990s witnessed a qualitative and quantitative aggravation in the unemployment rate to the extent that this problem has become one of the most serious challenges threatening the future of economic and social development not to mention the

political stability in Egypt. This study, however, is based on the assumption that the real danger lies in the fact that unemployment is but a reflection of deteriorating investment and development rates both quantitatively and qualitatively. With this assumption, the study analyzed the relationship between the level and pattern of investment and the unemployment problem in Egypt, with a view to reaching a set of policies that would raise the level and efficiency of investment in Egypt in order to achieve labor-intensive growth.

The analysis has shown that the unemployment problem in Egypt witnessed a qualitative and quantitative deterioration during the 1990s. It also indicated that the main reason for this deterioration was the failure of economic policies in general and investment policies in particular to achieve high and labor-intensive growth rates. These policies led to the deterioration of investment rates and the existence of investment patterns that are not consistent with employment objectives. This was ultimately reflected in the inability of the economy to generate productive employment opportunities.

In light of these results, it is evident that any remedy to the unemployment problem is bound to fail if undertaken in isolation from investment policies. Also, to continue with the current investment policies without initiating changes would undoubtedly lead to more unemployment. Subsequently, the logical conclusion is that in order to deal with the unemployment problem seriously, the government needs to reconsider development policies and patterns in general and investment in particular.

In this respect, the paper presents two sets of general proposals since developing a comprehensive strategy to handle the unemployment problem is beyond the scope of this paper. The first set of proposals is related to the investment policies necessary for achieving high and sustainable investment and growth rates, while the second deals with the investment incentives that would achieve labor-intensive growth.

***The First Set: Investment Policies***

The previous analysis has shown that achieving high and sustainable investment and growth rates is a prerequisite for effectively solving the unemployment problem. In order to achieve this goal, we present a number of proposals some of which are related to the macroeconomic policy and others are related to improving the investment climate. On the macro level, it is important to develop stable, timely and comprehensive policies to reinforce confidence in the economy and also to help investors plan their future policies. Moreover, it is necessary to immediately implement an integrated set of monetary and financial policies to activate the domestic market. Lastly, it is essential to start implementing a structural reform program especially in the trade and financial sectors and also in the area of institutional reform.

As for the policies related to creating a favorable investment business climate, we believe that the basis for any such attempt has to start first with an agreement on a new social contract between the government and investors based on mutual confidence and complete transparency. It should also be based on division of labor and partnership between both sides. This contract should also view permissibility as the rule and restrictions as the exception. This must be followed by overcoming the obstacles that continue to impede the level and efficiency of investments. Such obstacles include, for example, the problems related to the complexity and lengthy procedures of tax administration, the high direct tax rate on corporate profits, the multiple indirect taxes, as well as the problems related to dispute settlement and dealing with customs departments in transport terminals. Lastly, there are the problems related to the low standard of vocational training and the shortage of some technical skills.

***The Second Set: Investment Incentives***

Although raising growth and investment rates is a prerequisite for tackling the unemployment problem effectively, it is not sufficient by itself. To achieve labor-intensive growth, investment incentives must be reconsidered. In this regard, we propose linking incentives and the policy of exemptions (taxes, credit terms and



social security) with the employment level. It is also essential to narrow the profitability gap between exporters and those producing for the domestic market. The government has already taken some effective measures to devalue the real exchange rate of the Egyptian Pound against the Dollar. While such a devaluation is a positive step, maximizing its results for exports requires reducing customs tariffs on final products and improving the customs rebate and drawback systems.

Also, instituting policies to support small enterprises could play an important role in creating more employment opportunities. In this respect, we propose that support services (financial, marketing, technical and technological) be provided as an integrated package instead of providing each one separately along the line followed by Korea and India which proved to be more effective in supporting these industries. Such services should be continued until we are certain of the competitive capability of the enterprise (Lall 2000). We also propose the use of novel approaches to support small enterprises, such as the “cluster development” the “franchise” and the “trademark” approaches.

In conclusion, we would like to stress that although encouraging private investment and enhancing its efficiency is a necessary condition for reducing unemployment, it is not sufficient by itself. This should be coupled with policies aimed at curbing population growth, raising the levels of education and training, and lastly, dealing with labor market distortions.

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