The Business Environment in Egypt

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Abstract

After decades of state domination of economic activity, many governments around the world are increasingly relying on the private sector to foster economic growth. Starting from the premise that it takes a competitive business environment to ensure greater and more efficient private sector participation in economic growth, this paper assesses both the macro and institutional aspects of the business environment in Egypt.

Three conclusions were drawn from this study. First, despite the significant economic reforms undertaken recently by the Egyptian government, the private sector initiatives are still insufficient to drive Egypt's growth and are far behind private sector contribution in other developing countries. Although this unsatisfactory response could be a manifestation of the common 'wait and see' investors' behavior accompanying most reform experiences, the study reveals that, other factors in both the macroeconomic and institutional environment explain this response. Second, while the stabilization reforms in Egypt have been judged successful by international standards, the structural component of the reform program is lagging behind. The slow pace of privatization, high tariff levels, young stock market, and underdeveloped insurance and pension systems hamper private sector efficiency. Third, the survey which was conducted in early 1998 by ECES shows that the institutional climate deprives private firms of the means to compete in a highly competitive global market. According to the survey finding, the most critical elements that should be considered in private sector development are tax administration, the judicial system, support services, and education and vocational training in this order.

Finally, private sector development is only one element of Egypt's growth. The emergence of a viable private sector also hinges on a major sustained effort to develop competent, capable government.

ملخص

بعد عقود طويلة من سيطرة الدولة على النشاط الاقتصادي، بدأت كثر من الحكومات في الاعتماد المتزايد على القطاع الخاص في دفع خطى التنمية. ونظراً لأن كل من النظرية الاقتصادية والواقع العملي قد أوضحا أن تعظيم فاعلية وكفاءة مساهمة القطاع الخاص في النشاط الاقتصادي تتوقف في المقام الأول على مدى توافر مناخ استثماري ملائم، فإن هذه الورقة تركز على تقييم المناخ الاستثماري في مصر، ببعديه الاقتصادي والمؤسسي. هذا وقد انتهت الورقة إلى ثلاثة نتائج رئيسية: أولاً أنه على الرغم من الجهود التي بذلتها الحكومة المصرية في مجال الإصلاح الاقتصادي، إلا أن مشاركة القطاع الخاص في النشاط الاقتصادي مازالت محدودة نسبياً سواء بالمقارنة بمعدلات النمو المستهدفة في مصر، أو بالمقارنة بحجم وكفاءة القطاع الخاص في بعض الدول النامية. وقد أوضح التحليل أيضاً أن محدودية مساهمة القطاع الخاص ترجع في حقيقة الأمر إلى بعض مواطن الضعف في كل من المناخ الماكرو اقتصادي والإطار المؤسسي. ثانياً، أوضحت الدراسة أنه على الرغم من نجاح برنامج الاستقرار المالي إلا أن الإصلاح الهيكلي يحتاج إلى دفعة قوية، وخاصة في مجال الخصخصة بمفهومها الشامل، البورصة، نظام التأمينات والمعاشات، وأخيراً في مجال تحرير التجارة. ثالثاً كذلك أفصحت نتائج الاستبيان الذي أجراه المركز المصري للدراسات الاقتصادية في أوائل عام ١٩٩٨، عن أن القطاع الخاص يعاني من بعض المعوقات المؤسسية، ومن أهمها: إدارة الضرائب، نظام التقاضي، الخدمات المساندة، التعليم والتدريب المهني. وختاماً، يجدر التنويه إلى أنه على الرغم من أهمية المساهمة الفعالة والكفؤة للقطاع الخاص في تحقيق معدلات نمو اقتصادي مرتفعة ومتواصلة، إلا أن هذا يعد شرط ضروري ولكنه غير كاف. فالأمر يتوقف أيضاً على مدى وجود حكومة قوية قادرة على إدارة الاقتصاد القومي.

I. Introduction

After decades of state-dominated economic activity, governments around the world are increasingly relying on the private sector to foster economic growth. Governments are becoming less engaged in the direct provision of goods and services and more active in developing markets, creating supporting institutions and providing safeguards to ensure equitable distribution.

While this broad observation is hard to dispute, the question arises as to what is necessary to engender greater and more efficient private sector participation in economic growth. In answer to this question, economists have now come to believe that private sector decisions depend on the incentive structure reflecting the relative scarcity of resources as well as the incentive structure provided by the prevailing institutional framework (Serven and Solimano 1993; Clague 1997; Ul Haque 1995). The broad definition of the incentive structure is often referred to as 'the business environment.' A sound business environment is based on two complementary preconditions: an appropriate and stable macroeconomic environment, on the one hand, and efficient institutions, on the other.

Based on the premise that it takes a combination of economic and institutional reforms to persuade the private sector to be more active, this paper assesses the business environment in Egypt. The discussion addresses three questions in particular: Is the Egyptian private sector taking the lead in economic growth at present? Does the macroeconomic environment offer the necessary conditions for private sector development? And finally, does the institutional climate encourage private firms' growth and competitiveness? These questions are relevant to Egypt today, given that the government recently took significant steps to improve the business environment. The state of private sector development, however, is still far below the level needed to drive Egypt's growth, to foster its integration in the world market and to ensure a decent living standard for Egyptian citizens.

This paper is organized as follows: Section II offers a brief analysis of the private sector development in Egypt to date, Section III assesses the macroeconomic environment with a view to determining the most critical areas that require further reform, Section IV relies on the findings of a survey conducted in early 1998 on a random sample of firms to identify the most binding institutional constraints to private sector operations in Egypt.[1] It also provides a detailed analysis of these constraints for

[1] This survey, "Egypt's Business Environment" was conducted by the Egyptian Center for Economic Studies

companies of varying economic activities, size and ownership structures. Changes in those constraints over time, as well as a cross-country comparison, are also analyzed. Section V concludes this analysis on the business environment in Egypt.

II. Private Sector Development in Egypt

In the early 1990s, the government of Egypt began implementing more liberal policies to allow the private sector to lead economic growth. Have these policies produced an agile and vibrant private sector that can bear the responsibility of economic growth? This section briefly reviews the evolution of the private sector's relative importance, composition and characteristics.

Relative Importance

Recent empirical evidence suggests that the role of the private sector in the Egyptian economy is expanding. But much remains to be done considering if both the scope of the private sector in other emerging markets, and the Egyptian government's goal of achieving a sustainable annual GDP growth rate of 7 to 8 percent.

Table 1 indicates that the private sector contribution to GDP increased from 61 percent in 1991/92 to 66.4 percent in 1996/97, from 53 percent to 60 percent excluding agriculture. Despite this positive increase, the private sector has neither regained the level of its contribution to GDP which amounted to 85 percent prior to the 1952 Revolution, nor does it compare well to the private sector's share of GDP in countries with similar level of development, such as Brazil (80 percent), Uruguay (74 percent), and Indonesia (72 percent) (Moore 1995; World Bank 1994). Although the private sector share in implemented investment rose from 46.5 percent to 51.5 percent during the same period, it is still low compared with an average of 73.8 percent in developing countries *(Table 2)*.

Table 1. Private Sector Indicators: Egypt

	1987/88	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97
Private share in GDP (%)	62.4	61.2	61.8	61.7	62.6	63.3	66.4
Excluding agriculture (%)	54.0	53.8	54.4	54.4	55.6	56.6	60.4
Private share in implemented investment (%)	36.7	46.5	33.3	33.5	40.9	49.2	51.5
Private share in bank loans (%)[a]	71.7	64.2	62.7	61.2	66.8	69.7	72.3
FDI (US$ millions)	1,124.7[b]	1,152.0	1,139.6	1,320.8	0.782.7	0.626.9	0.769.7

[a] Total bank loans extended to the business sector at the end of the fiscal year.
[b] 1990/91.
Source: CBE, *Annual Report*, 1993/94; CBE, *Economic Review*, different issues; and Goldman Sachs, 1997.

(ECES) in early 1998.

Moreover, a World Bank study (1997a) indicates that the recovery of private investment in Egypt from 6.6 percent of gross national income (GNY) in 1992/93 to 9.4 percent in 1995/96, was not sufficient to regain its average level of 15 percent before the reform or to compensate for the public investment contraction. The result was a moderate increase of gross domestic investment from 14.8 percent of GNY in 1992/to 16 percent in 1995/96. This is relatively low compared to the domestic investment level of 26.7 percent in 1989/90 and 25 to 30 percent in other emerging markets.

The Egyptian economy experienced a decline in foreign direct investment (FDI) flows of almost 50 percent between the years 1991/92 and 1996/97. The current FDI to GDP ratio of less than 1 percent is arguably lower than what is needed to bridge the investment/savings gap, especially in the short run, and lower than the corresponding level of 3 percent in other developing countries in 1996 *(Table 2)*.

In short, it is clear that the increased private sector participation in the last three years is not sufficient to drive Egypt's growth. The relatively limited role of the private sector is also apparent considering the size of the government in the Egyptian economy. Although the size of government, measured by the share of government expenditure in GDP, has been reduced noticeably from 36 percent in 1993 to 28 percent in 1996, Table 2 indicates that it is still relatively high in Egypt compared to an average of 22 percent in other countries.

Table 2. Private Sector Indicators: Cross-Country Comparison, 1996 (%)

Country	Share of private investment in gross domestic fixed investment	Share of FDI in GDP	Share of government expenditure in GDP
Egypt	59.1	0.9	28.4
Chile	80.0	5.5	16.8
Mexico	79.1	2.3	22.6
Thailand	77.6	1.3	18.0
Korea	76.0	0.5	24.8
Malaysia	69.8	4.5	35.1
Indonesia	60.5	3.5	16.6

Source: World Economic Forum, *The Global Competitiveness Report*, 1997 (share of government expenditure in GDP); World Bank, *World Development Indicators*, 1998.

Composition

In terms of sectoral distribution, private investment in Egypt has grown at different rates across economic activities, which explains the significant change in investment composition in 1996/97 compared to 1991/92.

As shown in Table 3, the productive services sector witnessed the highest growth rate in private investment during this period. The result was an increase in the productive services share of private investment at the expense of both the commodity and social service sectors. Private firms are increasingly turning to transportation, communications and tourism to invest. This trend is expected to continue, especially because the government announced last year that all future power generation projects will be constructed on a build-own-operate-transfer (BOOT) basis for the first time in Egypt. Since then, the private sector has begun to invest in infrastructure, and there have been three bids for BOOT in airport projects and two planned BOOT projects to develop roads. In addition, cellular phone concessions have been sold to private firms and port services opened to private investors (The United States Embassy 1998a).

While the commodity sector's share in private investment decreased, within this group the relative importance of the agriculture and industrial sectors increased. The only commodity sector that registered a decline in its share of private investment is the petroleum sector. Despite this downward trend of private investment in the petroleum sector, industry and petroleum continue to be the leading sectors, followed by tourism and agriculture, that consistently attract more than 40 percent of private investment (Table 3). To date, 12 new industrial cities with 2,000 productive factories have been developed, the majority of which are privately owned (Ministry of Economy 1998). Table 4 shows that the private sector generates the most value added in all activities, with the exception of petroleum, money and banking, electricity, and insurance. It also indicates that the private sector's share in GDP in all economic activities has increased over the period between 1991/92 and 1996/97, again with the exception of petroleum and electricity.

Table 3. Distribution of Private Investment between Economic Sectors (%)

	Share in total private investment	
	1991/92	1996/97
Commodity Sector	58.9	55.9
Agriculture	7.7	10.1
Industry and mining	23.6	27.5
Petroleum and its products	25.5	14.9
Electricity	0.0	0.6
Construction	2.1	2.8
Productive Services	14.5	22.1
Transportation and Suez Canal	4.3	7.4
Trade, banking and insurance	3.3	3.5
Hotels and restaurants	6.9	11.2
Social Services	26.6	22.0
Total	100.0	100.0

Source: Calculated from CBE, *Economic Review,* various issues; and CBE, *Annual Report,* various issues.

Table 4. Share of Private Sector in GDP by Economic Activity (%)*

	1991/92	1996/97
Commodity Sector	62.8	68.8
Agriculture	98.8	98.7
Industry and mining	58.1	74.0
Petroleum and its products	17.3	13.3
Electricity	0.0	0.0
Construction	70.8	73.8
Productive Services	62.1	68.6
Transportation and Suez Canal	47.9	55.8
Trade	89.7	94.4
Money and banking	29.3	30.4
Insurance	39.5	41.2
Hotels and restaurants	84.7	85.3
Social Services	54.9	55.3
Total GDP	61.2	66.4
Total GDP excluding agriculture	53.8	60.4

*GDP at factor cost

*Source:*CBE, *Annual Report*, various issues.

As for the distribution of private investment among tradables and nontradables, a recent study by the World Bank (1997a) indicates that private investment has been increasingly concentrated in the nontradable sectors. Several factors explain this pattern, including the shift in relative prices of tradables and nontradables in favor of the latter; the high export transaction costs which make it more profitable to sell in the domestic market than to export; and the fact that new investments are mainly dominated by small firms which do not enjoy economies of scale and therefore are not engaged in export activities.

Characteristics

Three salient features characterize the private sector in Egypt and are likely to influence its power to drive the economy on a growth trajectory: the dominance of small and micro firms, the prevalence of the legal partnership form and the presence of a large informal sector.

The structure of the private sector in Egypt has a dual nature in terms of size; on one end, there is a large number of small and micro firms, but on the other end, there is a limited number of large firms. Small and micro enterprises represent nearly 98 percent of private economic units, they create nearly three-quarters of all private jobs and produce an estimated 80 percent of the country's private value added (Guigale and Mobarak 1996). If we exclude the agricultural sector, the figures will decline; however, the magnitude of small- and micro-size firms will still be significant. Despite their dominance, small- and micro-size firms are not participating efficiently in Egypt's growth. First, small firms suffer more than large firms from institutional constraints, as will be discussed in Section IV. Second, they serve mainly low-income consumers and provide low-quality, low-price products. Third, most of these firms use obsolete technologies. Conversely, while large-size firms are relatively well developed, there are too few to foster large private-sector growth.

As for the legal status of private firms, in 1992, most private establishments in non-agricultural activities were incorporated either in the form of individual proprietorships (47 percent) or partnerships (48 percent), while private joint-stock firms represented only 4.4 percent of all private firms (World Bank 1994). The implication is that more than 90 percent of private firms take the form of a partnership and are run on a family basis rather than on a corporate basis. In addition, most private firms in Egypt are not traded on the stock market, and although some have been listed recently, this is done for tax reasons and not to enlarge the shareholders' base.

Another important characteristic of Egyptian private investment is the large informal sector. Despite the lack of accurate figures on the size of the informal sector in Egypt, different studies indicate that the majority of small and micro enterprises are informal. For example, in 1991, these were estimated 2.28 million informal enterprises (The Alexandria Business Association 1996). EFG-Hermes estimates that the informal sector represents nearly 40 percent of the total Egyptian economy (EFG-Hermes 1997). The large share of the informal private sector may be due to the legacy of socialist policies, cumbersome regulatory regimes and high transaction costs. The implication is that informal assets can not be used in efficient and legally-secure transactions nor can they be used as collateral.

Based on this analysis, it is evident that despite some positive signs of development, the Egyptian private sector is not yet able to act as a catalyst to growth. The moderate growth rate of private investment, the decline of FDI inflows, the dominance of weak and underdeveloped small and micro enterprises, the large informal sector, the family-based management strategies, and the inward orientation of most private firms, all reflect a shallow state of development in Egypt's private sector.

Investors claim that the business environment is responsible for their unsatisfactory performance. In their opinion, two major problems in the business environment still impede their growth and efficiency: a distorted macroeconomic incentive structure and cumbersome institutional constraints. The former problem results in weak incentives for investing and the latter in high transaction costs and a lack of competitiveness. The following section identify the macroeconomic constraints that are still impeding private sector operations in Egypt and addresses institutional barriers to further private sector development.

III. Macroeconomic Reforms: Uneven Progress

The experiences of other countries, particularly in East Asia and Latin America, suggest that high degrees of macroeconomic stability, credibility and sustainability are of paramount importance to ensure a strong private sector response to economic incentives (Serven and Solimano 1993).

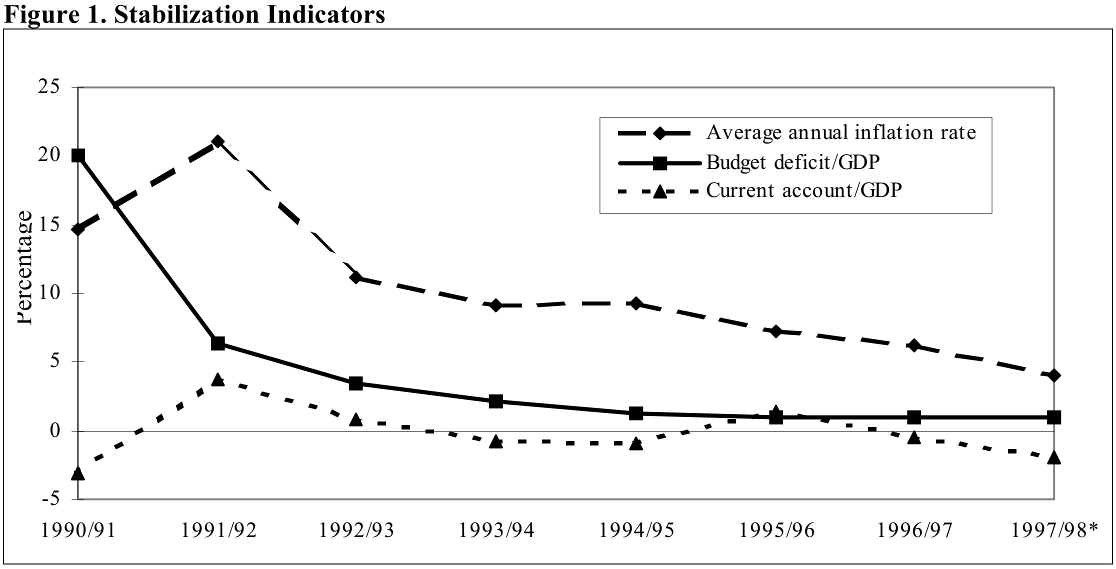
This section investigates the framework of macroeconomic incentives in Egypt to see if it provides the necessary prerequisites for private sector-led growth. What follows is a brief review of both the stabilization and structural reform efforts to date, as well as recommendations on the most critical areas requiring further reform.

Successful Stabilization

Domestic reforms in Egypt under the Economic Reform and Structural Adjustment Program (ERSAP) have focused mainly on stabilizing the economy. The collective impact has been substantial since 1990/91.

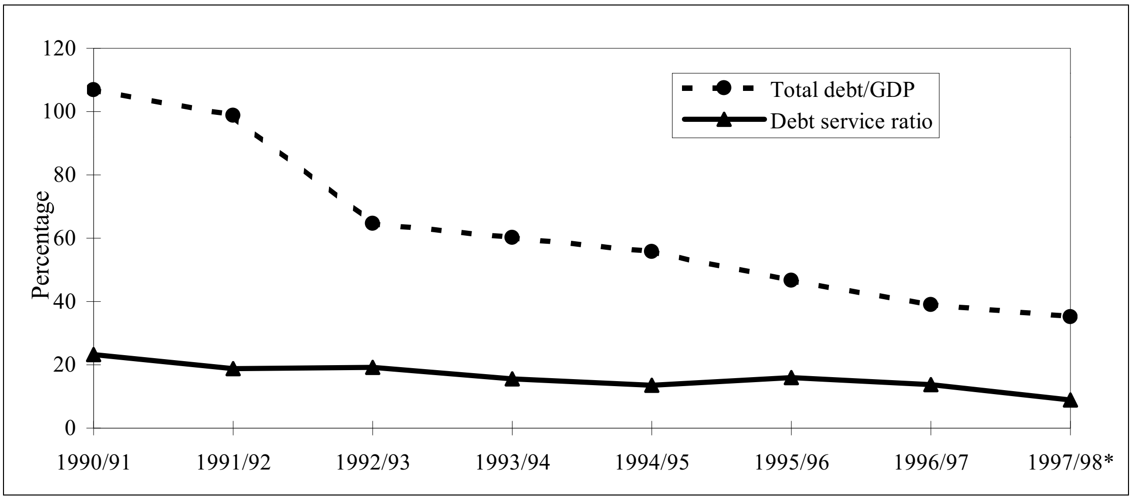
The public deficit to GDP ratio shrank to internationally competitive levels, double-digit inflation was broken and the current account-balance deficit as a percent of GDP decreased significantly *(Figure 1)*. The exchange rate was devalued and unified, and the Egyptian pound has remained stable between £E 3.33 and £E 3.39 to the US dollar over the last few years. Under conditions of fiscal adjustment, open-capital account, and an interest differential between Egyptian pound and dollar-denominated assets, foreign reserves increased from $6.1 billion to $20 billion, covering more than 16 months of imports (Ministry of Economy 1998). As a result of reforms and attractive returns on the stock market, portfolio inflows have increased from an average of only $4 million in the early 1990s to $654 million in 1996/97 (Ministry of Economy 1997). External debt indicators also improved during the same period *(Figure 2)*.

Figure 1. Stabilization Indicators



*Estimated
Source: Ministry of Economy, *Recent Economic Statistics*, July 1998.

Figure 2. Debt Indicators



* Estimated

Source: Ministry of Economy, *Recent Economic Statistics*, July 1998.

Uncompleted Structural Adjustments

Structural adjustment efforts in Egypt have focused on consolidating the gains of macroeconomic stabilization as well as intensifying the targeted structural adjustment through financial sector reform, privatization, deregulation, and trade liberalization.

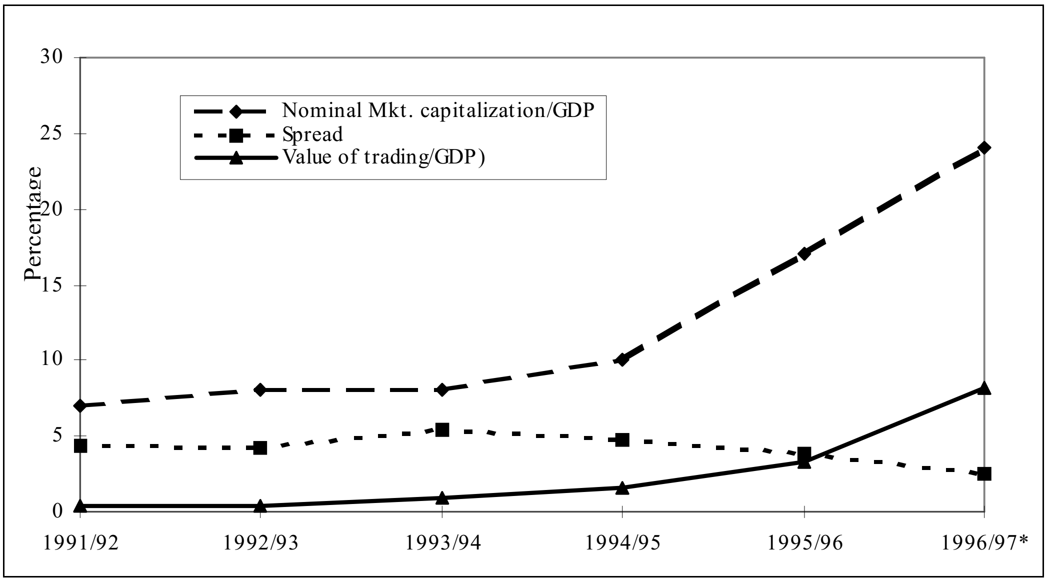
Financial Liberalization

Reform of the financial sector has led to several positive improvements including greater efficiency in financial intermediation, reversal of the dollarization phenomenon, and revival

of the stock market as apparent in the market capitalization and trading volume indicators *(Figure 3)*. Despite these tangible developments, Egypt's financial system still suffers from

deficiencies: 70 percent of bank assets are controlled by state-owned banks; most private banks concentrate on short-term commercial lending mainly to large- and medium-size private firms; the insurance industry is underdeveloped and highly concentrated; and the stock market does not participate effectively in private sector finance (World Bank 1997a).

Figure 3. Financial Indicators



* Estimated
Source: Subramanian, Arvind (1997), "*The Egyptian Stabilization Experience: An Analytical Retrospective,*" ECES, Working Paper No. 18.

Privatization

The privatization process has been accelerated over the last year partially due to improved financial indicators. By July 1998, the government privatized 91 out of 314 companies (only 9 were sold to anchor investors), with total sales proceeds of £E9.1 billion, representing almost 14 percent of the total book value of State Owned Enterprises (SOEs), which are estimated to be worth £E 63.8 billion.[2] More importantly, the privatization process has been expanded in the past two years to include joint-venture banks, public banks and public insurance companies.[3] The Egyptian government has recently been discussing Build-Operate-Transfer (BOT) schemes as a means of attracting increased private investment for infrastructure, particularly electricity generation, transportation and telecommunications. Nevertheless, in Egypt the size of SOEs relative to GDP is about 30 percent, relatively high compared to an average of 11 percent for other developing economies (Anderson and Martinez 1998). In addition, it should be noted that the limited sales to anchor investors leaves the governance structure of privatized firms largely unchanged, and hence undermines the potential welfare effects of privatization.

Trade Liberalization

2 Published data from the Ministry of Public Enterprises.

3 The Commercial International Bank (CIB) was the first joint-venture bank to be privatized in 1993, followed by the Egyptian American Bank (EAB) in 1996.

The Egyptian government has implemented serious unilateral, regional and multilateral measures to open its trade system.[4] While tariffs have shown a downward trend, the present trade-weighted nominal average tariff of 28 percent exceeds the world average (8.2 percent) and even the average tariff of other developing countries (21.4percent). This contributes to low productivity and threatens efficient resource allocation. Coupled with other factors, the cascading nature of the tariff structure creates an anti-export bias estimated at 19.4 percent in 1997 (Ministry of Commerce and Supply 1998). Finally, administrative and foreign trade practices have not moved in the same direction as tariff reform, thus increasing trade-related transaction costs.

Deregulation

To induce more private sector contribution to economic activity, the Egyptian government has launched a program to deregulate the economy. This includes simplifying company

[4] Unilateral trade liberalization efforts included substantial reduction in tariff and non-tariff barriers. Reforms in this area include: reducing the maximum tariff from 160 percent prior to 1990 to 50 percent in 1997, and hence narrowing dispersion from 0.7 -120 percent to 5 - 50 percent. The nominal unweighted average tariff fell slightly from 33 percent in 1988 to 24.62 percent in 1998, while the weighted average tariff was estimated at 28 percent in 1998 (Ministry of Commerce and Supply 1998). In addition, the Egyptian pound has been made convertible, although it is not traded abroad. Foreign exchange restrictions were abolished, and foreign currency transfers are now completely free. In terms of multilateral and regional trade efforts, Egypt is adhering to the World Trade Organization's requirements and is close to signing an association agreement with the European Union. The Egyptian government is currently negotiating with the United States on different mechanisms to expand economic relationships with countries of Eastern and Southern Africa by establishing a common market, and with Arab countries to revive the Arab Free Trade Area project with particular emphasis on trade and investment.

registration, customs procedures and approval processes, and issuing laws to facilitate business operations (Ministry of Economy 1998).

In response to Egypt's successful financial stabilization and the prospect of improved structural adjustment, real GDP growth increased from 1.9 percent in 1991/92 to 4.7 percent in 1994/95 and then to almost 5 percent in 1996/97 and 1997/98 (Ministry of Economy 1998). Despite these positive developments, Egypt's competitive position, compared to countries in East Asia, is not satisfactory in terms of economic growth, trade performance, openness, saving, and investment *(Table 5)*.

Reforms Ahead

Three conditions are necessary to guarantee that the macroeconomic climate is conducive to private sector development: stability, credibility and sustainability. While the two first conditions have been achieved in Egypt, uncompleted structural reforms still undermine sustainability.

Looking ahead, Egypt's challenge will be to maintain financial stability and international credibility while pursuing further structural reforms. Significant structural reforms are necessary to capitalize on the stability and credibility that has been realized and to help achieve sustainability, hence guaranteeing a more positive private sector response. To this end, increasing the pace of privatization, trade liberalization, financial sector development and deregulation is crucial. A more rapid and wider privatization process including infrastructure and public monopolies is important for increasing competition, allaying fears

Table 5. Selected Indicators for Egypt and Some Fast-Growing Economies

Country	Average annual growth rate of GDP 1990-1996	Trade/GDP 1996	Average tariff rate 1996	Gross national savings/GDP 1996	Gross domestic investment/GDP 1996
Egypt	3.7	0.43	22	16.7	16.89
Chile	7.2	0.46	11	23.81	25.07
Hong Kong	5.5	2.66	0	33.07	30.46
Mexico	1.8	0.58	11	18.95	16.74
Korea	7.3	0.64	7.9	34.07	38.29
Singapore	8.7	2.99	0.4	49.99	35.83
Thailand	8.3	0.75	9.3	35.48	43.19
Indonesia	7.7	0.47	6	30.75	28.48
Malaysia	8.7	1.62	15	35.48	41.37

Sources: World Bank, *World Development Indicators,* 1998; The World Economic Forum, *The Global Competitiveness Report*, 1997.

of policy reversibility and encouraging private sector investment and the repatriation of capital. Future privatization efforts should include changing the management as well as the ownership of firms in order to maximize the benefit of the shift from public to private ownership. In this regard, sales to anchor investors should be more encouraged. In addition, greater openness through continued reduction of trade barriers, deeper regional integration schemes and a more flexible exchange rate system will correct the bias in the relative prices, encourage firms to produce for global markets, help upgrade technology, and stimulate greater competition. Financial sector development helps mobilize savings, fuels accumulation of physical and human resources and thereby provides necessary inputs for private sector operations. Deregulation, through simplifying bureaucratic procedures, eliminating red tape, increasing market contestability, reducing transaction costs and securing property rights, is likely to induce more private investment

In addition to these reforms, evidence suggests that without efficient institutions and effective enforcement mechanisms, macro reforms will fail to deliver private sector-led growth. An enabling and competitive institutional environment is widely acknowledged as an indispensable complementary condition for encouraging private investment. The following section identifies those institutions that are impeding the private sector the most in Egypt.

IV. Institutional Environment: Constraints, Not Complaints

Economists have come to believe in recent years that unless institutional conditions are amenable to growth, heavy investment in human and physical capital and productivity development are likely to fail. Accordingly, sound institutions promote high market specialization and competitiveness, and reduce uncertainty and transaction costs; and hence they are crucial in influencing private sector growth and efficiency (North 1990; Olson 1997).

Despite the significant steps taken to improve the business environment in Egypt, private firms claim that many institutions still hamper their operations. This section analyzes the prevailing institutional constraints to private sector development. The analysis is conducted from the perspective of existing firms rather than potential firms. It relies on a survey conducted in early 1998 on 154 private firms. The sample was selected randomly from different economic activities including trade, manufacturing, oil, tourism, and construction. Firms of varying sizes and ownership structures were included to determine whether institutional constraints fall disproportionately on smaller firms and foreign companies. Variations in economic activities indicate whether certain constraints are binding across activities or are sector specific. A profile of the sample is given in the appendix.

Next, the paper compares the Egyptian institutional environment in comparison with other countries, to determine which institutions are still impeding private sector development the most in Egypt. Finally, each constraint is analyzed in detail.

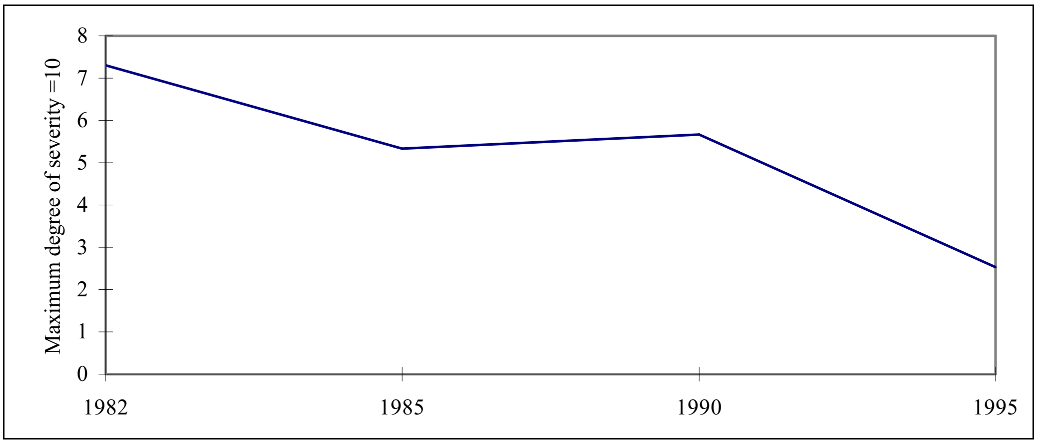
Cross-Country Comparison

Comparing the institutional environment in Egypt with that of other countries helps to gauge whether investors' complaints represent actual constraints or not. A cross-country analysis also gives investors and policymakers a reference point in negotiating for more reform and deregulation, attracting foreign direct investment, and setting growth targets. More importantly, in an increasingly liberalized and competitive global market, international technology, management skills and capital flows to economies that offer the most competitive and rich environment. Lagging behind international performance levels will be costly to Egypt.

In evaluating Egypt's institutional constraints, *The International Country Risk Guide* is a useful index that measures to what extent the institutional environment is business friendly. It focuses on five institutional variables: contract repudiation, expropriation risk, corruption, rule of law, and bureaucratic quality (Political Risk Services 1997).

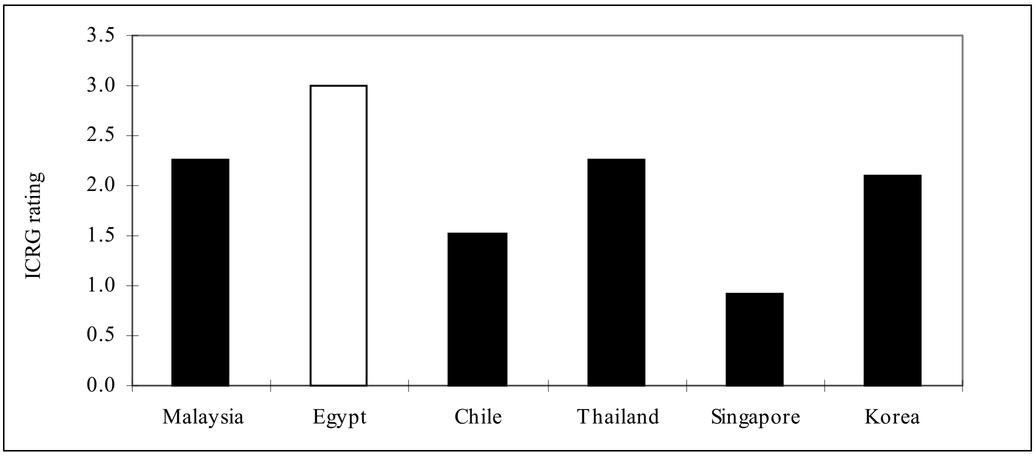
Figures 4 and 5 indicate that although Egypt's rating has improved somewhat during the period from 1991 to 1996, reflecting an improvement in its institutional framework, institutional constraints are still high in Egypt compared to many developing countries. This may partially explain the low level of private sector growth in Egypt, as well as the limited FDI inflows to Egypt over the past five years (Section 2).

Figure 4. Institutional Constraints in Egypt Over Time



Source: *International Country Risk Guide,* 1997.

Figure 5. Institutional Constraints in Egypt and Selected Countries



Source: International Country Risk Guide, 1997.

In short, this cross-country comparison shows that the business environment in Egypt is less attractive than many of its competitors, and that investors' complaints are likely to be real constraints. Therefore it is necessary to identify which institutions impede private sector development the most in Egypt.

Overall Assessment

This section provides an overall assessment of institutional constraints, their ranking according to severity, economic activity, firms' size and ownership structure.

ECES' Overall Ranking of Constraints

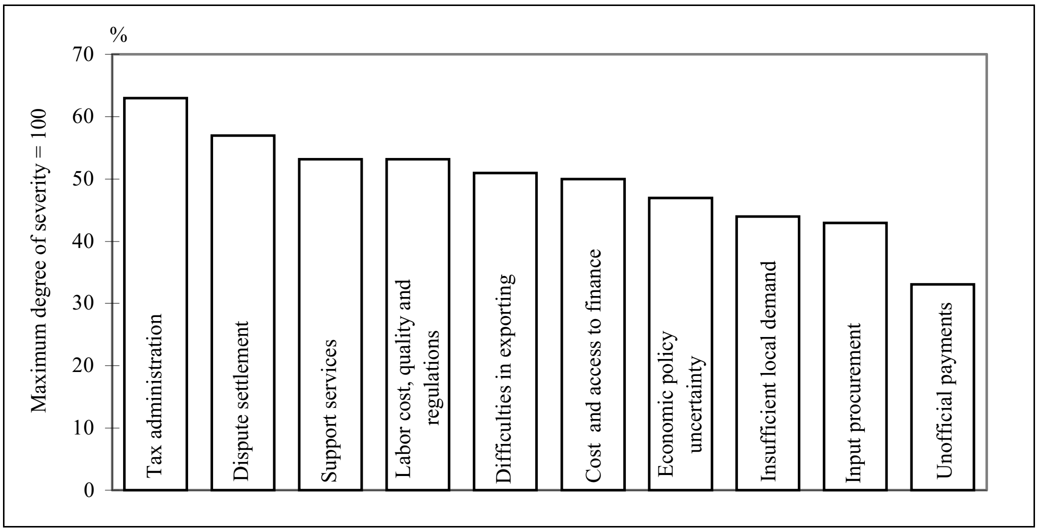
The ECES survey findings show tax administration, commercial dispute settlement, support services, and labor, respectively, as the primary constraints limiting the operation and growth of the private sector in Egypt. Unofficial payments were not considered a significant obstacle to private business in Egypt. Constraints rated as moderate include difficulties in exporting, cost and access to finance, economic policy uncertainty, insufficient local demand and input procurement problems. It should be noted that the non-regulatory obstacles, such as uncertainty of economic policy and insufficiency of local demand, rank relatively low. This indicates that institutional constraints are more problematic than economic obstacles to private sector development in Egypt*(Figure 6)*.

A comparison between the constraints entrepreneurs in Egypt faced in 1994 and in 1998 reveals some important changes (World Bank 1994). Some problems identified as major constraints in the past continue to hamper the growth of the private sector, while others have been ameliorated. On one hand, complicated tax administration, inefficient dispute settlement, unqualified labor and weak support services still hamper private sector operation. In fact, their relative importance has increased and they are ranked as the most severe constraints to private investment today. On the other hand, the severity of some problems, including cost and access to finance, bureaucratic procedures, and policy uncertainty, seems to have been reduced since 1994. The lower ranking of these constraints confirms the positive achievements of Egypt's reform program, particularly in terms of financial liberalization and deregulation.

Severity of Constraints across Economic Activities

The severity of institutional constraints facing private sector business also varies by economic activity. It is highest in the trade sector, followed by construction, manufacturing, and tourism, and is lowest in the oil sector *(Figure 7)*. Differences in the degree of severity reflect, to a certain extent, the specific. In addition, the extent to which the regulatory obstacles are binding varies by economic activity. As noted in Table 6, while tax administration is most binding to the trade sector, it is less constraining for the oil sector. Commercial dispute settlement is the primary constraint impeding investment in the construction sector, but this constraint ranks relatively low for the tourism sector. Moreover, unofficial payments are the primary complaint of firms in the construction sector, perhaps because these firms are involved in government procurement. Labor problems are felt more acutely by firms in the oil sector because the oil industry is highly sophisticated, and foreign firms operating in the oil industry are more likely to adhere to rigorous domestic labor laws.

Figure 6. Overall Ranking of Institutional Constraints



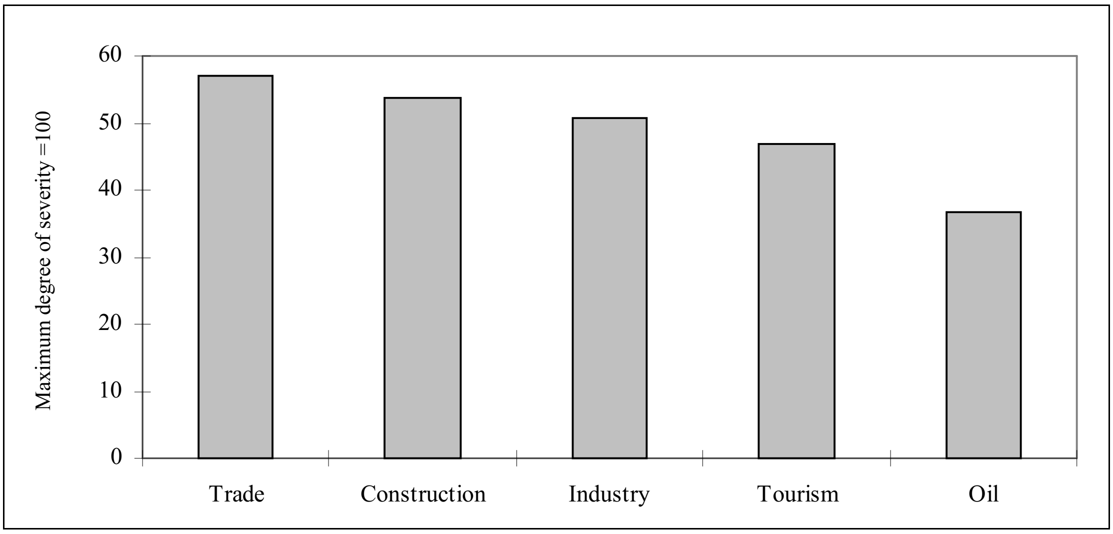
Source: ECES survey results, 1998.

Severity of Constraints by Size of Firm [5]

The severity of institutional constraints to business also varies accordingto the size of the firm. On average, small firms suffer more than large ones from institutional constraints *(Figure 8)*. This is especially apparent in tax administration and dispute settlement, because small firms cannot afford accountants and lawyers and their lack of collateral restricts their access to affordable credit. The only constraint that proved to be less problematic for small

firms is labor issues. This is mainly because most small firms are family businesses, and the enforcement of labor regulations is weak in small firms, especially those employing less than 10 workers.

Figure 7. Institutional Constraints by Economic Activity



Source: ECES survey results, 1998.

Table 6. Ranking of Institutional Constraints by Ownership, Size and Economic Activity

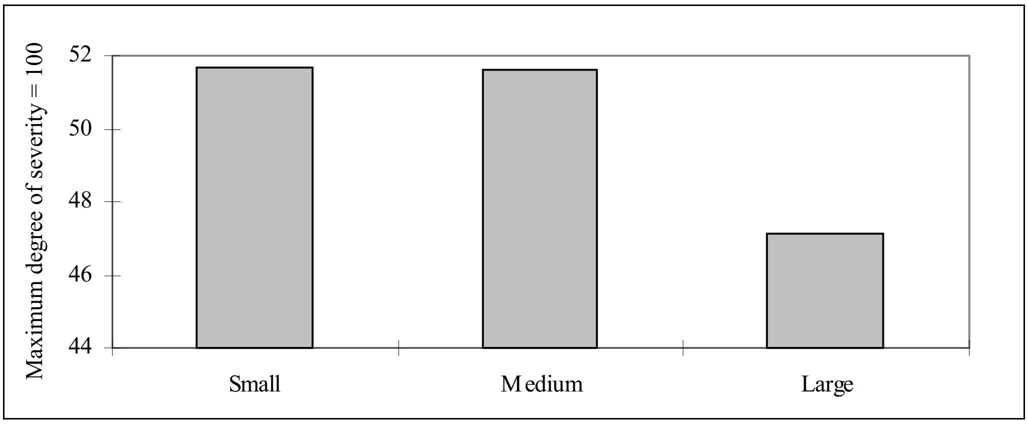
	Economic policy uncertainty	Labor cost, quality & regulations	Cost of access to finance	Input procurement	Tax admin.	Insufficient local demand	Difficulties in exporting	Support services	Unofficial payments	Dispute settlement
Ownership										
Local	51	52	53	44	65	43	56	NA	NA	59
Foreign	37	54	40	39	56	46	36	NA	NA	51
Size										
Small	50	48	56	44	73	46	54	50	35	63
Medium	38	54	59	43	62	43	58	62	38	58
Large	49	57	44	43	56	43	47	52	29	52
Activity										
Industry	46	51	49	43	64	46	51	53	33	56
Oil	38	58	25	39	42	25	13	44	10	54
Trade	58	64	54	48	74	46	50	65	28	63
Tourism	48	55	64	29	50	45	44	41	28	39

[5] Small firms are defined as employing less than 50 workers, medium-sized firms employ from 50 to 100 workers, and large firms are those that employ more than 100 workers.

Construction	52	43	46	52	69	36	63	51	39	70

Source: ECES survey results, 1998.

Figure 8. Institutional Constraints by Size of Enterprise



Source: ECES survey results, 1998.

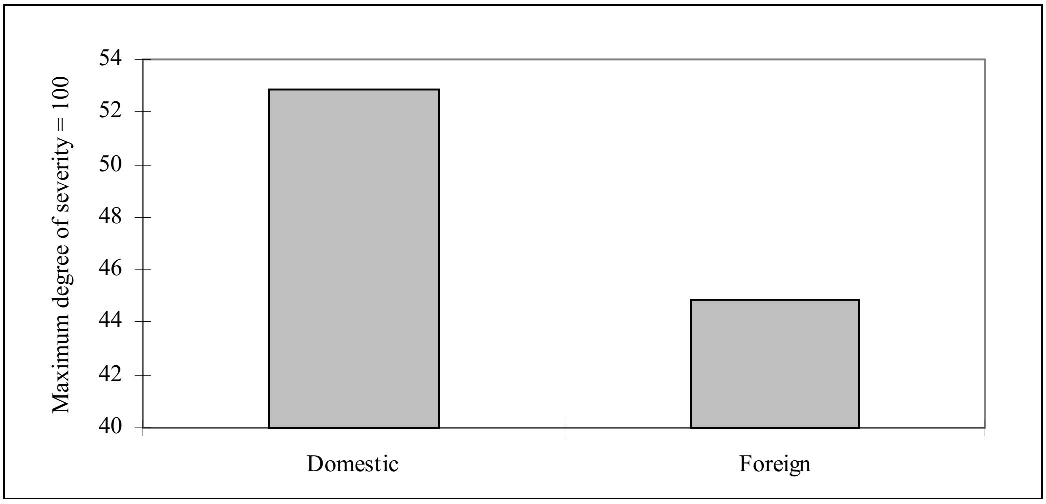
Severity of Constraints According to Ownership

Institutional constraints also differ according to the ownership structure of the firm. Figure 9 shows that domestic firms suffer far more from regulatory and institutional constraints than foreign firms. This could be attributed to the fact that most foreign firms included in the sample were operating in the oil sector, which is subject to international contracts. Table 6 shows that although foreign firms suffer less than domestic firms from institutional constraints in general, this does not apply for labor and size of the market.

Diagnosis of Institutional Constraints

While the overall ranking of constraints is useful, it obscures details which could be important for policy making. Table 7 reveals some interesting details about constraints to doing business in Egypt.

Figure 9. Institutional Constraints by Ownership



Source: ECES survey results, 1998.

Table 7. Detailed Ranking of Obstacles to Private Operations in Egypt (%)

Constraint	*Ranking**	*Constraint*	*Ranking**
Tax administration		**Finance**	
a. Lack of trust between tax collectors & tax payers	69	a. Cost of finance	63
b. Inefficiency of the dispute system	67	b. Collateral requirements	55
c. Arbitrary estimation of taxable profits	65	c. Time to obtain approvals	53
		d. Required documentation	44
Supporting services		e. Availability of finance	27
a. Domestic transportation	63		
b. Information services	59	**Local demand**	
c. Availability and quality of training services	58	a. Lack of information on domestic market	60
d. Availability of technical assistance services	57	b. Complexity of government procurement regulations	59
e. Marketing and distribution	56	c. Inefficiency of marketing/distribution	50
f. Airports and maritime port services	55	d. Demand insufficiency	44
g. Laboratories for testing standards	53		
h. Qualified warehousing facility	52	**Input procurement**	
i. Maintenance and repair services	51	*Imported inputs*	
j. Health certification and procedures	42	a. Tariffs and surcharges	68
k. Telecommunications	36	b. Customs procedures	65
		c. Port services	58
Labor		d. Information about suppliers	49
a. Lack of skilled labor	61	*Domestic inputs*	
b. Difficulties in firing labor	37	a. Quality and specification	49
c. High cost of labor	35	b. Price	47
d. Union activities	12	c. Delivery on time	45
		d. Availability	39
Difficulties in exporting			
a. Marketing and distribution companies	57	**Unofficial payments**	
b. Tariffs on imported inputs	56	a. Each import transaction	43
c. Drawback and tax rebate system	51	b. Tax collectors	38
d. Export procedures	44	c. Each export transaction	37
e. Absence of export credit	42	d. Labor insurance inspector	24
f. Insurance services	38	e. Loans from banks	20
Economic policy uncertainty			
a. Lack of transparency in law making	69		
b. Lack of respect for property rights	56		
c. Policy instability	53		

* Maximum degree of severity = 100
Source: ECES survey results, 1998.

Tax Administration

Tax administration has been cited as the major constraint to private sector development in Egypt. This problem has long been among the primary complaints of the private sector, and thus is a chronic problem that requires serious consideration (World Bank 1992; World Bank 1994; Galal 1996). Investors do not complain about the extent of taxes as much as the complicated tax administration itself which increases transaction costs and impedes firms' efficiency. In terms of specific problems related to tax administration, the private sector complains most about the lack of trust between tax collectors and taxpayers, inefficiency of the dispute settlement system and arbitrary estimation of taxable profits, in that order. Investors report that they do not know how much taxes they actually have to pay. The main problem is that the criteria for tax assessment is ambiguous, and tax collectors have unlimited discretionary powers which lead tax officers and taxpayers to extreme initial bargaining positions. Investors also complain that the process of tax assessment and collection is time consuming and costly. In many instances, it leads to underreporting of taxable income or tax evasion and often takes years to resolve in court. Moreover, taxpayers complain that tax collectors tend to overestimate taxes due to the collection targets which act as incentives to tax officers (World Bank 1992; Hassan 1996).

Dispute Settlement

The ECES survey helps clarify several aspects related to dispute settlement problems as a constraint to private sector business *(Table 8)*. It indicates that the average time needed to resolve disputes in court is four and a half years compared to one year outside of court. The survey also shows that the main reasons for disputes are bankruptcy, broken agreements, problems with the tax authority, and quality of supplies, ranked according to their importance. As for the parties involved in disputes, nearly two-thirds of disputes take place between private firms, while disputes with government bodies represent 22 percent of total disputes. The remaining share of disputes is with banks, labor and SOEs. Apart from being time consuming, investors also complain that litigation is expensive and that the judicial system is not well acquainted with commercial disputes related to market economies. Much of the existing legislation was developed during Egypt's period of centralized control, inwardness, and direct government participation in the economy, which makes it incompatible with a dynamic private sector-dominated, open market economy. New trade agreements and the growing importance of intellectual property rights also require that the

Table 8. Disputes Settlement*

	Small	Medium	Large	Average
Time needed to resolve a dispute				
In court (years)	4	5	5	4.5
Out of court				
Less than 1 year (% of responses)	92	87	87	90
More than 1 year (% of responses)	8	13	13	10
Distribution of disputes across different actors (% of total disputes)				
Private	21	61	59	61
Public	0	7	4	5
Labor	0	0	7	5
Banks	0	1	3	2
Government	4	22	26	22

*According to the survey, the three most frequent causes of disputes are: inability to pay due to bankruptcy on customer's side, unpaid checks and breaking of agreements.

Source: ECES survey results, 1998.

current laws be revised. In addition, investors complain about the lack of contract enforcement mechanisms and the poor enforcement of laws. In their view, the judicial system must be reformed and improved to cope with their needs in a global market-oriented economy.

Supporting Services

Interviews with private firms, conducted as part of the ECES survey, suggest that the high cost and poor quality of support services are major impediments to productivity growth. According to the survey results, the most important problems are:

- *High cost/low quality of domestic transportation.* Investors activities are hampered by the poor maintenance of transport vehicles, lack of equipment and inefficient handling and loading services. Businesspeople point out the need for improving the transportation services by lowering tariffs on transport vehicles, increasing refrigerated transport modes and introducing new freight lines.
- *Absence of adequate information about suppliers and markets.* Despite the remarkable development in information services, access to information remains a problem in Egypt. Information is not accurate and is costly to obtain, especially to small and micro-size enterprises which constitute the bulk of firms in Egypt.
- *Shortage of marketing and distribution skills and networks.* Private firms complain that marketing, distribution services and after-sales services are scarce and inefficient.
- *Lack of technical assistance.* Evidence suggests that Egyptian firms require technical assistance in production planning, quality management and technology upgrading.

- *Poor training services.* Private firms rate the inadequacy of training centers as a major obstacle.
- *Inadequate port services.* Investors claim that the high cost, low quality and complicated procedures of port services are among the major factors hampering their productivity growth. A recent study indicates that Egypt's seaport charges for imports are triple that of competing countries, which raises the CIF cost (cost including insurance and freight) for imports to Egypt by over 10 percent (World Bank 1997a).

Labor

Although the Egyptian labor force is internationally competitive in terms of cost, the lack of high-quality human resources is one of the most acute challenges facing firms' efficiency. Private investors rank the lack of skilled and semi-skilled labor and qualified local managerial staff as the most binding labor constraint to their operations. Education and the vocational system seem to be a source of this human resources weakness, since they do not reflect the skills demanded in the local labor market.

Besides the quality issue, the survey results show that restrictive labor laws are the second major complaint of the business sector in terms of labor issues. Egypt's job security law, legally embedded in layoff restrictions, are among the most stringent in the world. Firms are not allowed to lay off workers without governmental approval, which renders dismissals costly or even impossible when operations must be down-sized or new technologies must be introduced to maintain competitiveness. Although many firms have succeeded in circumventing labor regulations, this constraint still negatively affects firms' competitiveness.[6] On one hand, labor regulations give investors a strong incentive to shift production to capital-intensive techniques, which puts Egyptian firms in a disadvantageous position in an increasingly competitive economy. On the other hand, such regulations may also be a significant disincentive for firms to invest in training since disciplinary actions against misconduct and low productivity are not enforceable. Finally, the ECES survey indicates that labor union activities are weak and do not pose any problems to the private sector. Although this may be good from a business perspective, it reflects a distortion in the labor market.

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[6] Firms can circumvent layoff restrictions in many ways such as requiring their employees to sign undated letters of resignation upon employment, developing contractual arrangements whereby employees are recognized only as part time, etc.

Difficulties in Exporting

Difficulties in exporting are regarded by the investors surveyed as a moderate problem. This is because most firms in Egypt produce for the domestic market rather than for export and therefore are not seriously affected by export problems. The fact that relative prices of tradables and nontradables are shifting in favor of the latter could explain why many producers find it more profitable and less risky to sell in the domestic market rather than in the world market. With regard to the ranking of specific export constraints, firms' primary concern is high tariff rates on imported inputs. The average nominal tariff rate is still high in Egypt, and the cascading tariff structure creates an anti-export bias, as mentioned previously. The lack of distribution and marketing companies ranks second. As for drawback and temporary-admission systems, which rank third, investors complain that these systems are still cumbersome, involving many steps which are costly in both time and money. Finally, firms complain about complicated export procedures and the absence of export credit and insurance services, in that order.

Finance

There is a consensus among firms that the cost of credit is their leading financial constraint. The second constraint is collateral requirements, followed by the excessive time needed to obtain approvals, and finally the lack of available and accessible finance. It should be noted that availability of finance is the least reported problem related to finance, perhaps because the high cost of capital and the complicated, and often impossible, collateral requirements deter firms from seeking formal credit, especially in the case of small and micro-firms. The result is a reliance on informal sources of finance, which are more costly and hence negatively affect firms' profitability.

More importantly, the survey highlights the constraining features of the financial system from a private-sector perspective. First, most private commercial banks concentrate on short-term commercial lending (70 percent of total consolidated loan volume) mainly to medium-size and large companies. The result is that large firms lack long-term finance, and small and micro-size enterprises are excluded from the formal credit system. Given that almost 90 percent of firms operating in Egypt are small or micro enterprises, this raises the cost of production. Second, the small but rapidly growing stock market does not yet play a significant role in private sector finance. Although many large companies are listed on the stock exchange, few are actually traded stocks. In fact, the incentives to be listed on the stock market are based on tax preferences, not on the possibility of raising capital by floating shares. In addition, derivative markets (futures and options) are virtually nonexistent. Third, the insurance industry is underdevebped and highly concentrated. Total assets to GDP of all insurance companies in Egypt (life and non-life) were about 4 percent in 1995, while life insurance assets alone were 38 percent of GDP in a sample of developed economies. Moreover, the reserves and surplus of the social insurance and public pension fund systems, nearly 29 percent of total financial assets, are beyond the reach of the private sector. Insurance companies hold the bulk of their funds, 77 percent, in fixed-term bank deposits and government bonds (The American Chamber of Commerce in Egypt 1996; World Bank 1997a).

In general, the survey shows that private business access to formal credit is difficult and costly and restricted to large firms. The majority of the private sector, in particular small and micro firms, relies mainly on retained earnings, family and friends to finance their business.

Economic Policy Uncertainty

One of the most interesting results of the 1998 survey is that uncertainty of economic policy ranks relatively low as a constraint, while it ranked as the most binding constraint in the early 1990s (World Bank 1992; Galal 1996). Economic policy uncertainty is no longer perceived by the private sector as highly constraining to their operations. Seven years since the implementation of the ERSAP seems to have been sufficient time to establish an acceptable degree of credibility in economic policy and to protect investors from policy reversibility. Moreover, recent years have witnessed closer coordination between the private sector and the government in the process of decision making. Nevertheless, businesspeople still complain about ad hoc policies and sudden changes, lack of respect for property rights and asymmetry in information

Insufficient Local Demand

Local demand does not present a serious obstacle to private sector development according to interviews with entrepreneurs. Egypt's large population, estimated at 61.7 million in 1997, and a substantial informal sector suggest a potentially large home-demand base. Moreover, the local demand rate of growth, which is more important than its absolute size, indicates an upward trend in demand in the past two years, which is likely to continue with the expected acceleration of private sector participation in economic activities. Interviews with entrepreneurs, however, indicated that the most binding problems related to local demand are the lack of information about the domestic market, the complexity of government procurement regulations and the inefficiency of marketing and distribution channels, in that order. Data also shows that local demand is highly concentrated in basic goods, which explains the low level of home-demand sophistication (Fawzy and Galal 1998). Unsophisticated demand explains, partly, why Egyptian firms are not strict about quality; the lack of laws to protect consumers contributes as well. Consumer protection law (Law 57 of 1939 as amended Trademarks Law) is underdeveloped in Egypt. This limits contestability as unprotected consumers tend to avoid new brands, thus making the cost of reputation building for new entrants particularly high and hampering any attempt to innovate.

Input Procurement

The survey results concerning inputs or supplies highlight serious challenges to firms' competitiveness. One of the most striking findings is that investors complain more about imported inputs than about domestic ones. In reference to imported inputs, firms reported that tariffs and surcharges, followed by complicated customs procedures and port services, have adverse implications for efficiency. As for domestic inputs, investors stated that the most binding constraint is the poor quality of products and inconsistent quality, followed by late delivery.

Unofficial Payments

Bribes were cited as the least severe problem facing businesspeople in Egypt today. Cross-country comparison, however, suggests that investors underestimate this problem, and that the Egyptian economy suffers from both grand and petty corruption (Moody-Stuart 1996). Even if we accept these positive survey results, the issue is not only the adverse impact of unofficial payments on transaction costs, but more importantly that it leads to uncertainty, because investors are not sure if they will pay the same amount of money next time or if they will be able to bribe again in the case of a change in government officials. What is more interesting than the size of bribes is to determine which transactions result in more unofficial payments and which economic sector suffers most from these payments. Survey findings indicate that bribery is more widespread: import and export transactions, tax collection, labor insurance inspection, and loans from banks, in that order. This seems to conform with the overall ranking of institutional constraints. Results also indicate that the construction sector suffers the most from unofficial payments, while the oil sector suffers the least. This is understandable if it is taken into consideration that a high percentage of the construction transactions are with the government and the construction operations are large factors which positively correlate to grand corruption. Conversely, the oil sector is subject to international contracts, and foreigners are usually more apprehensive about bribery than locals.

To sum up, the survey results support the conclusion that despite ongoing reforms, institutional reforms are crucial to private sector development. Tax administration, the judicial system, support services, education and vocational training are priorities for reform.

V. Conclusion

This paper investigated whether the private sector is taking the leading role in economic growth in Egypt, whether the macroeconomic environment offers the necessary conditions for private sector development and whether the institutional climate is amenable to firms' growth and competitiveness. The underlying argument of the analysis is that it takes both economic and institutional reforms for the private sector to and play that leading role. Several conclusions can be drawn from this analysis.

First, despite recent aggressive economic reforms, the private sector's initiatives are insufficient to drive Egypt's growth and are far behind the private sector contribution to economic activity in other developing countries. Although this unsatisfactory response could be a manifestation of the 'wait and see' behavior of investors, other factors in both the macroeconomic and institutional environment seem to be responsible for this inadequacy.

Second, while the stabilization reforms in Egypt have been successful by international standards, the structural component of the reform program is lagging behind. The slow pace of privatization, high tariff levels, a young stock market, and underdeveloped insurance and pension systems hamper private sector efficiency.

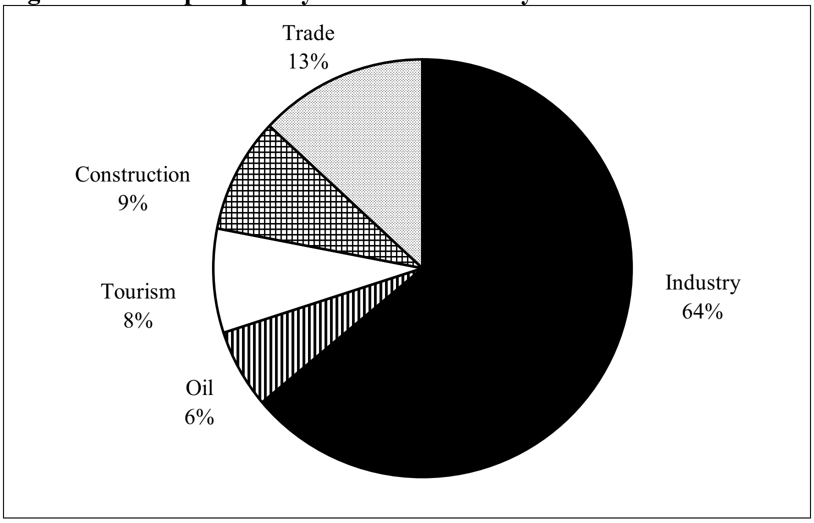
Third, the survey results show that the institutional climate deprives private firms of the means to compete in a highly-competitive global market. The most critical elements that to consider in further private sector development are tax administration, the judicial system, support services, education, and vocational training.

Fourth, private sector development is only one element of Egypt's growth. Complementary public investment in social services, infrastructure and the environment are essential. The health of the private sector also hinges on a competent, capable government.

Finally, a solid public-private partnership is indispensable for growth. It helps overcome private sector concerns about policy reversals and eliminates any constraints to private sector development.

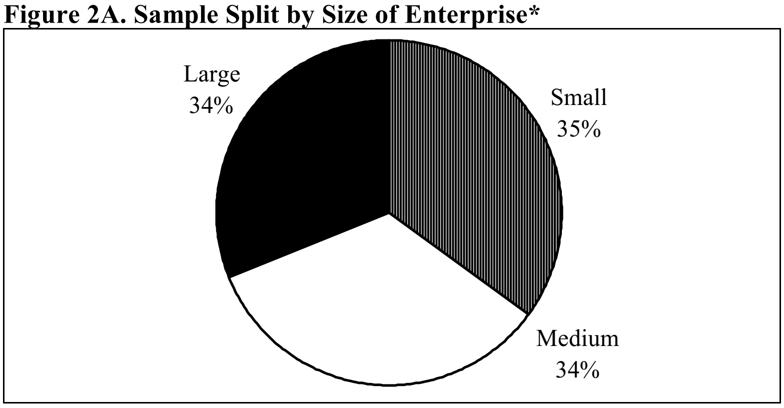
Appendix

Figure 1A. Sample Split by Economic Activity*



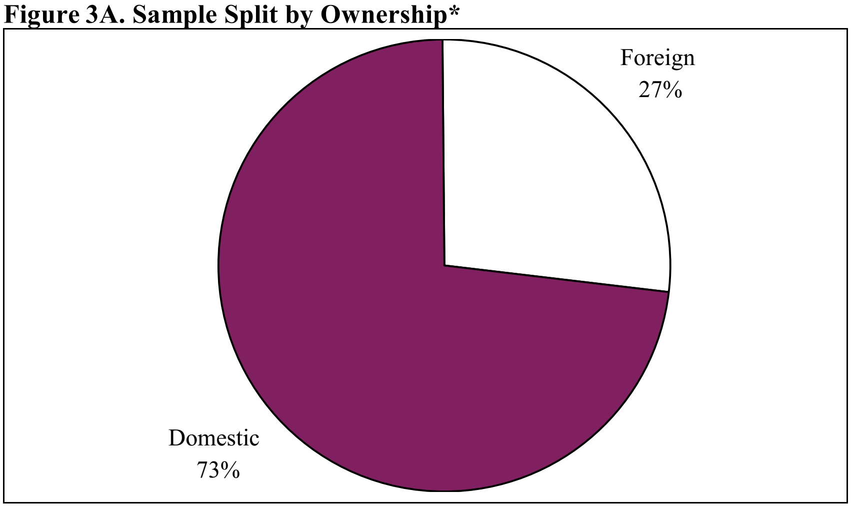
* Initially, economic activities were assigned weights according to their contribution to private sector output. In the actual sample, all weights remained in place except for the trade sector whose share was shifted to the industrial sector as the emphasis of the survey is on reviving the manufacturing sector.

Figure 2A. Sample Split by Size of Enterprise*



*Number of employees was used as an indicator of size. Firms employing less than 50 workers were considered small. Firms employing from 51 to 100 workers were considered medium size. Firms with more than 100 workers were considered large.

Figure 3A. Sample Split by Ownership*



* Foreign ownership refers to firms with any foreign participation.

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