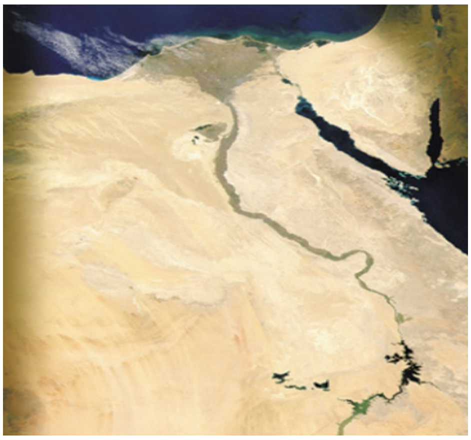
EGYPTIAN
NATIONAL
COMPETITIVENESS
COUNCIL

TAKING THE NEXT BIG STEP



THE 4th EGYPTIAN COMPETITIVENESS REPORT

CAIRO, MAY 2007

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The Report has been prepared in advance of the World Economic Forum on the Middle East, convened at the Dead Sea in May 2007, with the intent of stimulating discussion among policy-makers and leaders about the issues it raises and the policies it recommends. The support of the World Economic Forum in establishing the ENCC is especially acknowledged.

EGYPTIAN NATIONAL COMPETITIVENESS COUNCIL (ENCC)

At the Egyptian National Competitiveness Council (ENCC), leaders from business, academia, civil society and government collaborate to increase awareness of competitiveness and its implications for the economy and society.

MISSION STATEMENT

The mission of the Egyptian National Competitiveness Council is to spur efforts to improve the competitiveness of Egypt and to incite the public opinion and the business sector to give priority to such efforts in all domains.

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ACRONYMS

AfDB	African Development Bank
BB	Business Barometer
BCI	Business Competitiveness Index
BDS	Business Development Services
BIH	Bosnia and Herzegovina
BRC	Business Resource Center
CAPMAS	Central Agency for Public Mobilization and Statistics
CIDA	Canadian International Development Agency
DB	Doing Business
ECES	Egyptian Center for Economic Studies
ELMS	Egyptian Labor Market Survey
ENCC	Egyptian National Competitiveness Council
EOS	Executive Opinion Survey
ERF	Economic Research Forum
EU	European Union
FDI	Foreign Direct Investment
FTSE	Financial Times and the London Stock Exchange
GAFI	General Authority for Investment and Free Zones
GCI	Global Competitiveness Index
GCR	Global Competitiveness Report
GDP	Gross Domestic Product
ICT	Information and Communications Technology
IFC	International Finance Corporation
IMF	International Monetary Fund
IMP	Industrial Modernization Program
IT	Information Technology
LE	Livre Egyptienne (Egyptian pound)
LPG	Liquified Petroleum Gas
MGPC	Ministerial Group on the Production Committee
MOF	Ministry of Finance
MSME	Micro, Small and Medium Enterprises
NIB	National Investment Bank
OECD	Organisation for Economic Co-operation and Development
OSS	One Stop Shop
PM	Prime Minister
PPP	Public-Private Partnership
PR	Public Relations
R&D	Research and Development
SBIR	Small Business Innovation Research
SFD	Social Fund for Development
SME	Small or Medium Enterprise
SMEPol	Small and Medium Enterprise Policies
SSBC	Smart Service Business Center
T&T	Travel and Tourism
TTCI	Travel and Tourism Competitiveness Index
UAE	United Arab Emirates
UNDP	United Nations Development Programme
UNWTO	United Nations World Trade Organization
WEF	World Economic Forum

The Minister of Finance

DR. YOUSSEF BOUTROS-GHALI

Trends in today's world economy have created challenges for governments and firms around the world. The globalization of economic activity has made redundant traditional economic development models where the development efforts are led exclusively by governments. There is now more interest in private sector contributions to development, and an even more growing emphasis on public-private partnerships to promote economic development.

In line with this perspective, the Government is encouraging economic policy advocacy, led by the Egyptian National Competitiveness Council, through business leaders, industry groups, scholars, donors, and other leading experts, with a view to generating a dialogue on competitiveness among key stakeholders from widely diverse sectors. A discussion of experiences and reform initiatives will help determine which reform strategies are working, which are not, and which alternative courses of action could be pursued, all in the context of a public-private partnership. A critical issue highlighted in the process is the need for the private sector to build up its capacity in the areas of policy analysis, economics, strategy, and public relations in order to become a knowledgeable and strong partner in public-private discussions.

An important conclusion of this Report is that reforms are a continuous process and that institutionalizing change is crucial to the sustainability of reforms and improved competitiveness. Institutionalizing reforms requires a comprehensive strategy geared towards enhancing all aspects of competitiveness, be they regulatory reform, education, or workforce skills development.

Enhancing the competitiveness of Egypt's economy relies primarily on generating more value through improved productivity, quality, service and innovation. Increasing the competitiveness of the economy is the responsibility of both entrepreneurs and the Government. At the firm level, businesses must be able to design innovative and effective business strategies that can capture greater value in the international marketplace and generate greater competitiveness for Egypt. At the level of the government we will continue to develop and improve the business environment to make it a better conductor for investment, employment generation, innovation and exportation. We will continue to empower firms to change the economy and to increase national competitiveness.

Another important conclusion is that economic growth and income redistribution are complementary and mutually reinforcing. Without economic growth it will be difficult for governments to design and finance the redistribution components. At the same time, growth that is not accompanied by policies to address equity issues risks further disadvantaging marginalized groups. When growth policies and income redistribution policies are combined, growth is likely to be faster and provide greater opportunities for the poor.

The policy advocacy role that ENCC has undertaken since 2004 on behalf of its economic partners has in fact helped bring to the forefront many constraints to Egypt's competitiveness. More important, it has institutionalized a competitiveness dialogue among all interest groups. This dialogue analyzes, discusses and plans continuous improvements in the underlying sources of Egypt's competitiveness. It is the dialogue, structured networking and accompanying information flows among all participants that will benefit from competitiveness in the long run.

Youssef Boutros-Ghali
Minister of Finance

MINISTERIAL TESTIMONIALS

The Minister of Trade and Industry

ENG. RACHID MOHAMED RACHID

In welcoming this fourth issue of the Egyptian Competitiveness Report, it is important to reflect on the country's performance: its drivers, and its deterrents. The Egyptian economy has no doubt registered impressive progress in terms of growth, attracting FDI and increasing exports.

The Industrial Sector, which last year's Report singled out as the "Engine of Growth," has recorded unprecedented progress. With a growth rate of over 7 percent it has greatly contributed to the increase in non-oil exports of almost 52 percent over the last year. Exports have been diversified to include Furniture, Chemicals, Fertilizers, Garments, Electronics and Construction materials in addition to Egypt's traditional exports.

Industry is rapidly becoming a magnet for investment, both domestic and foreign. Institutional reform within the Ministry of Trade and Industry is geared toward solving outstanding problems such as availability of lands and training of human resources to suit the needs of the labor market.

Yet the drop in Egypt's ranking on the competitiveness measures is sending us a strong message that our work has by no means finished — there remains a great deal to be done. One of the major challenges that holds the country back from progressing down the road to sustainable growth is the huge number of rules and regulations that have accumulated over the years, rules that were created to serve a different type of economy, and are now incompatible with the new and modern economy we want to build. It is from this perspective that we should assess the proposal of this year's Report to scrutinize the backlog of rules and regulations and do away with those that are not needed or are outdated or unfriendly to business. This could liberate the productive sector from an unnecessary burden. I am looking forward to a concerted effort by different Ministries and institutions to take up this challenge and embark on yet another step to accelerate comprehensive reform.

Rachid Mohamed Rachid
Minister of Trade and Industry

MINISTERIAL TESTIMONIALS

The Minister of Investment

DR. MAHMOUD MOHIELDIN

This year's edition of the Egyptian Competitiveness Report coincides with the emergence of a key phenomenon on the investment front in Egypt, namely the inflows of unprecedented levels of foreign direct investment (FDI). While the phenomenon in and of itself is important, it is also taken as a proxy on the success of the government-endorsed reform agenda in terms of influencing the outlook for investment in Egypt. The sustainability of high levels of FDI inflows promises to elevate Egypt as the lead FDI recipient country on the African continent.

The seriousness with which the reform-oriented government which took office in mid-2004 has been addressing key constraints facing investment in Egypt has spurred accelerated growth momentum which promises to persist further. The economic pay-off from streamlining investment procedures, the harmonization of laws and regulations governing the establishment of companies in Egypt, fiscal reforms, enhancing access to finance and the smooth integration of the Egyptian economy in the global trade nexus is most likely to be high.

Regulatory reform, accompanied by transparency, is imperative for a healthy investment climate. The essence of regulatory reform is to allow businesses to shift the order of their priorities to addressing issues related to enhancing innovative capabilities, productivity and competitiveness, all of which are key determinants to survival in a global environment which does not accommodate second-tier competitors. The ultimate objective of reforms is, therefore, to allow Egypt to join the league of first-tier global competitors, with this status eventually translating into improved income levels for all Egyptians.

The current pace of regulatory reform is indeed ushering Egypt towards a new frontier. However, regulatory reform is not a chemical reaction, whereby results can be immediately observed. Regulatory reforms do trigger a continuum of outcomes, each of which occurs at its own pace. Because growth-related constraints are time-bound, each step taken forward eliminates a set of obstacles, while at the same time triggering a new set. Policy-makers have therefore injected dynamism into the reform process, by scrutinizing the regulations emerging as impediments to progress in a timely manner.

This year's report focuses on a new and innovative approach to free the economy in a drastic way from the regulations which may impede further progress. The Egyptian Government by and large is keen on exploring all options that support the current process of reform and sustain the gains which have been so far achieved. The policy messages of the 2007 Report are indeed cherished, and their implementation is most likely to be a key element of the Government's agenda for the current year.

Mahmoud Mohieldin
Minister of Investment

MINISTERIAL TESTIMONIALS

The Minister of State for Administrative Development
DR. AHMED M. DARWISH

The Egyptian Competitiveness Report has reserved for itself a respectable place in the community due to the sincere efforts exerted by the composing team to produce such a well researched document.

We have chosen to transform from a centralized government playing all roles to a regulated market-based economy. In this respect, the name of the game, nowadays, for different competing economies is to attract investments, whether foreign or local. Regulations, which directly affect the complication of the work cycle, are believed to play a crucial role in this process. The issue of primary concern is striking a balance between regulations and competitiveness. Is there what we can label "*wise*" regulations? Those which will enforce discipline, avoid chaos, be transparent, fair, assure integrity, be accurate with no loopholes … and at the same time be easy to implement and fast track? Or is it the case of regulations versus competitiveness?

Should we decide to achieve wise regulations, several questions must be answered: How to do it? How long should it take? And how to manage the change?

Different alternatives are possible: on the one hand, the abrupt approach with sudden impact and on the other, the smooth, low risk, steadily increasing impact approach. The former consists of collecting existing regulations and modifying them, *the top-down approach*. The latter encompasses using the end-user requirements including goals, customer point of view, and supplier point of view to select candidate regulations for changing, *the bottom-up approach*. Yet a third alternative is possible. This entails challenging existing regulations and engaging stakeholders in the change process, *the comprehensive approach* ("guillotine").

A note worth mentioning regardless of the approach is that we have to keep in mind that we are not drafting these regulations only for large companies and investors, but more importantly for the vast economy composed of small and medium Enterprises (SMEs). This is a crucial criterion because I do not believe we have an entity making life easier for SMEs, the same way the General Authority for Investment (GAFI) is acting on behalf of major investors.

For managing the change, issues to consider include: whether the implementation is partial or across the board, the availability of the necessary legal and regulatory frameworks, the existence of suitable organizations to carry out the change, the availability of needed human resources and capacities, the assessment of the impact on the sector addressed and the needed level of awareness.

During the implementation phase we will face the challenge of using old structures to carry out new ideas. The same government entities will still provide services to investors. Since government services are a monopoly, (e.g. establishing companies and issuing licenses), the notion of a Service Level Agreement (SLA) defining the quality of service fades away. Thus, wise regulations without smart implementation will only be a small step forward. This clearly shows the need for clear guidelines to quantify this relation between the government, as a service provider, and those requesting and receiving the service. Deploying the SLA culture calls for planting several change leaders in each government entity followed by a major human resource development program.

Another essential success factor is to standardize the whole Egyptian Government on an agreed upon Enterprise Architecture capitalizing on linking national databases. This will guarantee the unification of workflow and ease of replication of documented processes within government.

Ahmed M. Darwish
Minister of State for Administrative Development

PREFACE BY

The Honorary Chair of the Egyptian National Competitiveness Council

Dr. HOSSAM BADRAWI M.D.

Once more, the Egyptian Competitiveness Report appears as the publication that honestly monitors the performance of the Egyptian economy, and benchmarks it against the performance of others, especially the emerging markets groups. The result of this survey points to the fact that we are doing a lot in Egypt, especially since July 2004, but it seems that others are running even faster. This is the game of competitiveness.

This decline in our competitive position calls for reflection. The reform-minded government of the National Democratic Party has certainly introduced commendable reforms, but the time has come to move from piecemeal to comprehensive reforms emanating from a coherent vision of the future.

Whatever this vision maybe, it is my belief that it is the quality of human beings that will decide the outcome. In last year's report, we emphasized the importance of human resources development and the creation of an enabling environment for innovation. The 2006 Report stated that "Today, everyone recognizes that we are moving rapidly towards a knowledge-based society and a technology-driven economy in a globalized, highly competitive world where ideas, goods and services know no political boundaries." It is precisely here that the importance of human development in general and education in particular gain their importance. Certainly, the output of education is usually measured against its ability to meet labor market demand. But, for me, the question is much deeper than that. Education is equivalent to building the human base of development and the best guarantee for a healthy and democratic society. I would argue that almost all the indicators of competitiveness in this Report can be correlated with the quality of education of a country.

It may be argued that there is nothing new in this. And this is true. What is needed now is to move from the repeated diagnoses of the problem towards solutions. And the solution, as the slogan of this Report suggests, is to TAKE THE NEXT BIG STEP.

Hossam Badrawi
Honorary Chair of the Egyptian National Competitveness Council

PREFACE BY
The Chair of the Egyptian National Competitiveness Council
HELMY ABOULEISH

It is a source of celebration to see the Egyptian Competitiveness Report in its fourth edition. Since we started the Report after the World Economic Forum in Davos in 2004, we have been working hard so that it becomes what it is now, a standard reference on the subject, and a forum for dialogue among the relevant actors especially the government, the private sector and the civil society.

As in previous reports, we have attempted to monitor the performance of the Egyptian economy as reflected in the competitiveness indicators published by the major rating reports. The efforts of the government were described in two ways: testimonials of the Ministers involved, and a detailed account of the tasks undertaken by the government.

As active partners in the process of reform especially since July 2004, we follow and support the serious efforts that have been made. What this year's report reveals, however, is that Egypt's rankings in the *Global Competitiveness Report* and the *Doing Business Report* fall below the country's potential. It is true we are making progress reflected in the World Investment Report where Egypt is next only to South Africa in attracting FDI. But it is also true that we rank low on multiple competitiveness measures. In this Report we focus on analyzing the reasons.

The Egyptian National Competitiveness Council (ENCC) will continue to create platforms for national dialogue on these issues. Finally, I would like to thank all those who contributed to the Report especially the Ministers who contributed testimonials and the authors and editors among others. Particular thanks are due to the World Economic Forum for its continued support and for providing the valuable data files for the competitiveness indices.

Helmy Abouleish
Chair of the Egyptian National Competitveness Council

EXPLAINING THE PARADOX: DECLINING COMPETITIVENESS RANKINGS DESPITE IMPRESSIVE RESULTS

Despite Egypt's currently healthy economic growth, the fourth Egyptian Competitiveness Report reveals that Egypt has slipped in various global competitiveness rankings this year. On the Global Competitiveness Index (GCI), Egypt fell from 52nd place in 2005 to 63rd in 2006. Egypt ranked 8th out of 13 Arab countries. Likewise, Egypt's rank on the Business Competitiveness Index (BCI) dropped from 71st to 76th place. And the country ranks among the lowest-performing economies on the Doing Business Index at 165th out of 175 countries, which was even further below its poor showing last year at 141st place out of 155 countries. One of the notable surprises of this year's Competitiveness rankings is the sharp decline in the macroeconomy pillar. In contrast to last year's ranking, where Egypt had climbed impressively from a score of 81st (in 2005) to 50th (in 2006), this year the same rank declined to 108th. Underlying this decline are four important factors: a budget deficit among the world's highest at around 9.3 percent of GDP, an inflation rate as high as 12.4 percent, and a high public debt and an unemployment rate of 10.9 percent.

Having realized the need to become a globally competitive country, Egypt has taken the slow path to economic reform, although picking up speed in the last few years, especially after July 2004. The government lowered the income tax rates and simplified compliance, improving government revenues in the process. Tariff rates were lowered and streamlined, resulting in increased revenues as well. Sharing the global realization that state ownership was not working as hoped, the government launched a program of public assets management to release many companies which must now compete in the marketplace to serve their customers. The government has achieved impressive gains in primary school enrollment and has made a conscious effort to attract strategic foreign investment. These reforms have had impressive results. The economy grew by 6.9 percent in 2006. Export revenues have grown considerably. Official unemployment has slipped to below 10 percent. The country recorded a healthy balance of payments surplus thanks to Suez Canal revenues, remittances from workers abroad and very health foreign investment at an unprecedented 7.5 percent of GDP.

DESPITE GOOD OVERALL RESULTS, INFLATION, BUDGET DEFICIT AND PUBLIC DEBT CHALLENGES REMAIN TO BE ADDRESSED

If Egypt is doing so well, why is it slipping in the rankings? There are several reasons. It seems that Egypt is successfully implementing piecemeal reforms, but is not implementing a full strength and comprehensive set of economic reforms. Or, to use the metaphor of the Nile, the economy is moving downstream in the right direction, but other countries are simply moving faster. Second, the continued budget deficits, debt and inflation brought down Egypt's macroeconomic rankings. Third, as nearly any small business owner in Egypt will confirm, there are many, many impediments to business in Egypt — especially for small and medium size businesses that would like to become formal businesses. The surveys indicate that lack of access to finance, government bureaucracy and lack of an adequately trained workforce are major impediments to business in Egypt. For this reason, Chapter 3 of the ECR focuses on this subject.

EXECUTIVE SUMMARY

FREEING THE SME SECTOR FROM OVER-REGULATION

Last year's ECR argued strongly in favor of a development strategy led by a dynamic and competitive manufacturing sector. This year, in Chapter 3, the focus is on small and medium enterprises. These SMEs represent the backbone of the Egyptian economy, accounting for 75 percent of employment and 80 percent of GDP. The current success which Egypt is enjoying with Foreign Direct Investment will not by itself be sufficient to absorb the employment pool -especially the lower skilled and unskilled segment of the workforce. Smaller local companies (MSMEs) are more likely to engage this workforce, taking advantage of local family ties, contacts, networks etc. But SMEs are the business sector which is disproportionately burdened by the current heavy regulatory regime. If these companies can be liberated from this burden and their spirit of enterprise encouraged and supported by a pro-business environment it will re-energize the sector with consequent positive effects on local employment and poverty alleviation. As the *Doing Business Report* has shown, three major impediments account for the underperformance of this sector: the cost and the difficulty of access to finance; the cumbersome regulations in dealing with licenses, and the protracted process of enforcing contracts. All this is reflected in a disproportionately high cost of doing business for SMEs compared to large enterprises. The labyrinth of rules and regulations, often unnecessary, stifles initiative and dampen productivity.

Paving the way out for enterprises in general and SMEs in particular will require a major "clean-up" operation. Therefore, Chapter 4 argues that it can be business as usual no longer. This year's Report proposes the "guillotine approach" to all rules and regulations that are not needed, that are illegal or that are not business-friendly. This will require a strong political will and a degree of coordination that has not characterized previous reforms. It will require courage on the part of civil servants to act in the national interest and to place this above narrow individual interests. A major objective of reform should be to combine competitiveness with pro-poor economic growth by making competitiveness an inclusive process. This in turn necessitates a fresh approach to the issues of employment and the quality of human resources. Creating productive and remunerative jobs while equipping people with the skills to fill them will be the best approach to combine global competitiveness with equitable income distribution and poverty reduction. The *Report* provides a powerful argument that sustainable growth and competitiveness can only be achieved if the objectives of equity and poverty alleviation are seriously addressed.

The Report is divided into five chapters. In Chapter 1, an analysis is provided of Egypt's competitiveness rankings in various sets of indicators published by international bodies, especially the *Global Competitiveness Report*, *Doing Business* and *The World Investment Report.* Chapter 2 presents an analysis of recent economic performance and the policies of the government in general and those of the Ministry of Finance, dealing with various macroeconomic challenges in particular. Chapter 3 focuses on the constraints facing small and medium enterprises (SMEs) as the sector that shoulders a disproportionate burden of costly regulations, and that has a great but unfulfilled potential for contributing to economic growth and job creation. Given the preponderance of regulations that constrain the Egyptian economy, Chapter 4 proposes an aggressive attack on these regulations using the innovative "guillotine approach." The Report concludes in Chapter 5 with a challenge to private, public and academic leaders to formulate a ***national competitiveness strategy*** that will go beyond the piecemeal approach.

TAKING THE BIG STEP: FROM PIECEMEAL TO COMPREHENSIVE REFORM

The Egyptian National Competitiveness Council invites all those concerned to contribute to this important and historic private-public dialogue. This ***national competitiveness strategy*** will need to focus on how to make *all* Egyptians more productive: men and women, younger or older, from all regions of Egypt. A national competitiveness strategy is therefore also a pro-poor economic growth strategy. A second challenge is to then monitor and evaluate the success of this strategy by continuing to monitor progress and report objectively based on annual benchmarks and objective indicators. The situation is urgent. The need for social and political stability causes the government to continue to expand the civil service and to maintain in place the food and energy subsidies that create Egypt's unsustainably high debt. At the same time, the government maintains a mesh of obstacles that constrain and restrain the creative energies of its people and cause many to lose heart. Egypt has benefited from high oil prices, sales of national assets and a boom in the Arab world. But if it does not equip the average Egyptian with better and more relevant skills for the workplace and if it does not end the regulations that impede productivity, it will lose the support of growing numbers. On the other hand, if these recommendations are implemented, more and more Egyptians will believe and support them. We must move beyond piecemeal to comprehensive reforms. It is now or never.

ملخص تنفيذي

تفسير المفارقة: لماذا تراجع ترتيب مصر على مؤشرات القدرة التنافسية رغم ما تحققه من نتائج متميزة في النمو الاقتصادي؟

على الرغم مما تحققه مصر في الوقت الراهن من نتائج متميزة في النمو الاقتصادي، يكشف التقرير الرابع للتنافسية المصرية عن تراجع في ترتيب مصر وفقا لمختلف المؤشرات العالمية للقدرة التنافسية في العام الحالي. فقد تراجع ترتيب مصر على المؤشر العالمي للقدرة التنافسية (GCI) من المركز الثاني والخمسين في عام ٢٠٠٥ إلى المركز الثالث والستين في عام ٢٠٠٦ . و جاء ترتيب مصر في المركز الثامن من بين ١٣ بلدا عربيا. وبالمثل، تراجع ترتيب مصر حسب مؤشر تنافسية الأعمال (BCI) من المركز الواحد والسبعين إلى المركز السادس والسبعين. كذلك جاء ترتيب الاقتصاد المصري متدنياً للغاية حسب مؤشر أداء الأعمال حيث احتلت مصر المركز الخامس والستين بعد المائة بين ١٧٥ بلدا، وهو ترتيب يعكس المزيد من التراجع حتى بالقياس إلى ترتيبها المتدني في العام الماضي حين احتلت المركز ال ١٤١ بين ١٥٥ بلدا. و قد كان التراجع الملحوظ في التقديرات التي حصلت عليها مصر في ركيزة الاقتصاد الكلي من المفاجآت اللافتة للنظر في تقديرات التنافسية لهذا العام. فعلى خلاف العام الماضي الذي سجلت فيه مصر تقدما باهرا فصعدت من المركز الواحد والثمانين (في عام ٢٠٠٥) إلى المركز الخمسين (في عام ٢٠٠٦)، تراجع ترتيبها هذا العام إلي المركز ١٠٨. ويعود هذا التراجع إلى أربعة عوامل مهمة : العجز في الموازنة العامة الذي بلغت نسبته حوالي٩,٣٪ من الناتج المحلي الاجمالي، وهي نسبة من بين أعلى النسب في العالم؛ و ارتفاع معدل التضخم الذي بلغ١٢,٤٪, و ضخامة حجم الدين العام, ونسبة البطالة التي بلغت ١٠,٩٪.

إن مصر، وقد أدركت ضرورة الارتقاء بقدرتها التنافسية على الصعيد العالمي، قد سلكت طريقا بطيئا في الاصلاح الاقتصادي وإن كانت قد أخذت في تسريع الخطى في السنوات القلائل الماضية وبخاصة منذ يوليو ٢٠٠٤. فقد قامت الحكومة بتخفيض معدلات ضريبة الدخل و تيسير إجراءات سدادها مما أدى إلى تحسن الإيرادات الحكومية. كما قامت بتخفيض الرسوم الجمركية وترشيدها وهو ما أسهم، بدوره, في زيادة الإيرادات. كذلك أدركت الحكومة، شأن سائر العالم، أن المشروعات المملوكة للدولة لاتعمل على النحو المرجو منها، فوضعت برنامجاً لإدارة الأصول العامة سعيا إلى إطلاق يد كثير من الشركات التي أصبح يتعين عليها الآن أن تخوض المنافسة في السوق كي تخدم عملاءها. وحققت الحكومة، فضلا عن ذلك، نتائج باهرة في نسبة الالتحاق بالتعليم الإبتدائي، كما بذلت جهدا واعيا لاجتذاب استثمارات أجنبية استراتيجية. وكان لهذه الاصلاحات نتائج مشهودة : فنما الاقتصاد في عام ٢٠٠٦ بنسبة بلغت ٦,٩٪, وزادت حصيلة الصادرات زيادة كبيرة وانخفضت نسبة البطالة الرسمية إلى حوالى ١٠٪, وحققت مصر، فضلا عن ذلك، فائضا ملحوظا في ميزان المدفوعات نتيجة للزيادة في عائدات قناة السويس، وتحويلات العاملين بالخارج، واجتذاب قدر لابأس به من الاستثمارات الأجنبية بمعدل غير مسبوق بلغ ٧,٥٪ من الناتج المحلي الاجمالي.

رغم هذه النتائج الطيبة بوجه عام يظل التضخم وعجز الموازنة والدين العام تحديات لابد من مواجهتها

إذا كانت مصر تحقق مثل هذه النتائج الطيبة فلماذا تراجع ترتيبها حسب مؤشرات القدرة التنافسية؟ إن هناك أسباباً عدة : فمصر، رغم نجاحها في تنفيذ بعض الاصلاحات الجزئية، لم تعمد حتى الآن إلى المضي بكامل قوتها، وبأقصى سرعة في طاقتها، نحو تنفيذ مجموعة شاملة من الاصلاحات الاقتصادية. بتعبير آخر، فإن الاقتصاد يتحرك الآن في الاتجاه الصحيح لكن بلداناً أخرى تتحرك على نفس الطريق بسرعة أكبر. السبب الثاني هو أن استمرار العجز في الموازنة والارتفاع في حجم الدين العام ومعدل التضخم قد أدى إلى تدني ترتيب مصر وفقا لمؤشرات الاقتصاد الكلي. أما السبب الثالث، وهو ما يؤكده كل أصحاب المشروعات الصغيرة في مصر، فيتمثل في وجود الكثير، بل الكثير جدا، من المعوّقات أمام المشروعات، لاسيما الصغيرة والمتوسطة منها، التي تتطلع للانضمام إلى قطاع الاقتصاد المنظم في مصر. فهناك, كما تبين المسوح الميدانية، معوّقات رئيسية تتمثل في صعوبة الحصول على التمويل, والبيروقراطية الحكومية، والافتقار إلى قوة عمل مدربة تدريباً كافيا. وعلى هذا, سوف يركز الفصل الثالث من تقرير التنافسية المصرية على هذه القضية.

تحرير المشروعات الصغيرة والمتوسطة من المعوقات الاجرائية

تضمن تقرير التنافسية المصرية في العام الماضي دعوة واضحة إلى وضع استراتيجية تنموية يقودها قطاع صناعي يتميز بالدينامية والقدرة على المنافسة. وسوف يتركز الفصل الثالث من تقرير هذا العام على المشروعات الصغيرة والمتوسطة التي تمثل العمود الفقري للاقتصاد المصري حيث تستوعب ٧٥٪ من العمالة ويبلغ نصيبها ٨٠٪ من الناتج المحلي الاجمالى. وهناك, كما يبين تقرير أداء الأعمال، ثلاث معوقات رئيسية تفسر ضعف أداء هذا القطاع : ارتفاع كلفة التمويل وصعوبة الحصول عليه ، والكم الكبير من اللوائح الثقيلة الوطأة فيما يتعلق بالحصول على التراخيص والاجراءات الطويلة اللازمة لتنفيذ التعاقدات. ويتجلى هذا كله في التفاوت الصارخ بين التكاليف المرتفعة التى تتحملها المشروعات الصغيرة والمتوسطة بالمقارنة بالتكاليف التى تتحملها المنشآت الكبيرة. و لاشك أن هذه المتاهة من القواعد واللوائح، غير الضرورية في كثير من الأحيان، تؤدي إلي شل روح المبادرة وتردي الانتاجية.

إن تمهيد الطريق أمام المشروعات بوجه عام، والصغيرة والمتوسطة بصفة خاصة، يقتضي القيام بعملية «تنظيف» كبرى. من هنا يخلص الفصل الرابع إلى القول بأن ممارسة الأعمال على النحو المعتاد ألآن لم تعد ممكنة, ويقترح تقرير هذا العام استخدام» منهج المقصلة» للإجهاز على كل القواعد واللوائح التي لالزوم لها, سواء منها غير القانونية أو المعوّقة للأعمال. وسوف يقتضي هذا إرادة سياسية قوية وقدرا من التنسيق لم تتمتع به الاصلاحات السابقه. وهو يقتضي أيضا أن تكون لدى موظفي الإدارة الحكومية القدرة على تغليب المصلحة الوطنية على المصالح الفردية الضيقة. ويجب أن يكون التوفيق بين تعاظم القدرة التنافسية والنمو الاقتصادي الذي يراعي مصالح الفقراء هدفاً رئيسياً من أهداف الاصلاح بما يجعل من الارتقاء بالقدرة التنافسية عملية شاملة. وهذا يستلزم بدوره نهجاً جديداً في معالجة قضايا التشغيل و كفاءة الموارد البشرية. فتوفير فرص جديدة للعمل المجزي والمنتج مع القيام ، في الوقت نفسه، بتزويد العاملين بالمهارات اللازمة لشغل هذه الوظائف هو أفضل سبيل للجمع بين القدرة التنافسية على الصعيد العالمي وتوزيع الدخل وتخفيف وطأة الفقر. ويطرح التقرير حججاً قوية تؤكد أن استدامة النمو والقدرة التنافسية لا يمكن تحقيقها ما لم يُبذل جهد جاد لتحقيق هدفي العدالة ونخفيف وطأة الفقر.

وينقسم التقرير إلى خمسة فصول. فيقدم الفصل الأول تحليلاً للترتيب الذي حصلت عليه مصر من حيث القدرة التنافسية حسب مختلف المؤشرات التى تنشرها الهيئات الدولية وبخاصة تقرير التنافسية العالمية وتقرير أداء الأعمال وتقرير الاستثمار العالمي. ويورد الفصل الثاني تحليلا للأداء الاقتصادي الراهن وللسياسات التي تنتهجها الحكومة بوجه عام، ووزارة المالية بصفة خاصة، بغية التصدي لشتى المعوقات على صعيد الاقتصاد الكلي. ويتركز الاهتمام في الفصل الثالث على المعوقات التي تواجهها المشروعات الصغيرة والمتوسطة بوصفها القطا ع الذي يتكبد تكلفة باهظة, وغير متناسبة, من جراء المعوّقات الاجرائية , والذي يملك فى الوقت ذاته طاقة كبيرة, لا تزال غير مستغلة, للاسهام في النمو الاقتصادي وفي توفير فرص العمل. وإزاء كثرة اللوائح المعطّلة التي تعيق حركة الاقتصاد المصري، يطرح الفصل الرابع اقتراحاً يستهدف التصدي بجسارة لهذه اللوائح باللجوء إلى نهج مبتكر يسميه « نهج المقصلة» . ثم يأتي الفصل الخامس في ختام التقرير ليطرح على قادة القطاعين العام والخاص والدوائر الأكاديمية تحدي صياغة استراتيجية وطنية للقدرة التنافسية تتجاوز نطاق الاصلاحات الجزئية الراهنة.

الخطوة الحاسمة : الانتقال من الاصلاحات الجزئية إلى الاصلا ح الشامل

إن المجلس الوطني المصري للتنافسية يدعو جميع المعنيين إلى الاسهام في هذا الحوار المهم والتاريخي بين القطاعين العام والخاص. فوضع هذه الاستراتيجية الوطنية للتنافسية يقتضي التركيز على كل ما من شأنه أن يجعل المصريين جميعا ، رجالا ونساءً وشبابا وشيوخا, أكثر إنتاجية على امتداد مصر كلها. من هنا، فإن الاستراتيجية الوطنية للتنافسية تصبح، بالضرورة، استراتيجية تنمية وطنية تراعي مصالح الفقراء. أما التحدي الثاني فيتمثل في متابعة هذه الاستراتيجية وتقييم مدى نجاحها ، من خلال رصد موضوعي لما يتحقق ،عاماً بعد عام، من تقدم انطلاقا من ضوابط ومؤشرات موضوعية. إننا بإزاء قضية ملحة ووضع لايحتمل التأجيل. ذلك أن الحاجة إلى كفالة الاستقرار الاجتماعي والسياسي تدفع الحكومة إلى الاستمرار في التوسع في جهاز الوظائف العامة والإبقاء على الدعم الحكومي للمواد الغذائية والطاقة مما يؤدى الى زيادة رهيبة فى حجم الدين العام يتعذر الاستمرار في تحمله. وفي الوقت نفسه، تضطرالحكومة إلى الإبقاء على مجموعة متشابكة من الاجراءات المعوقة التي تحدُّ من الطاقات الخلاقة للشعب وتقيّدها بما يدفع بالكثيرين إلى الاحباط. لقد استفادت مصر من ارتفا ع أسعار البترول، وبيع الأصول العامة, وفترة الرخاء الراهنة في العالم العربي. لكنها قد تفقد الدعم من جانب الكثيرين مالم تبادر منذ الآن إلى تزويد المصريين العاديين بمهارات أفضل وأقدر على تلبية احتياجات سوق العمل, ومالم تبادر بحسم إلى القضاء على جميع المعوقات الإدارية والقانونية التي تحول دون انطلاق الانتاجية ونموها المطرد. ولاشك أن تنفيذ ما يتضمنه هذا التقرير من توصيات سوف يدفع المزيد والمزيد من المصريين إلى دعمها والإيمان بها. لقد حان الوقت للانتقال من الاصلاحات الجزئية إلى الاصلاح الشامل. علينا أن نبدأ منذ الآن قبل فوات الأوان وضيا ع الفرصة الراهنة.

INTRODUCTION

"You can cross the river only in one jump."

This Egyptian Competitiveness Report (ECR) is the fourth issue in the series. Following the positive reception of last year's Report both at home and abroad, the ENCC decided to spare no effort in continuing the Report and improving it.

This year's Report attempts to explain a curious paradox: why are competitiveness rankings falling just as Egypt is continuing its reform and recording high rates of economic growth, growing exports, increased reserves and foreign investment? The question is answered first by compiling the ratings of the Egyptian economy in the major international reports, especially the *Global Competitiveness Report* and the *Doing Business Report*, and then explaining the drop in these ratings.

According to these Reports, Egypt scored lower compared to last year. An effort is therefore made to analyze in detail the different components that influence performance in order to pinpoint the areas of underperformance. The most surprising result is the one related to the macroeconomy pillar. Last year's Report came to the conclusion that *"Reforms have certainly improved the macroeconomic fundamentals, and what remains is to deepen these reforms by going down to the micro level and introducing structural reforms of factor markets and the regulatory framework."* Yet the Macroeconomy score in the Global Competitiveness Index has dropped from 50^{th} to 108^{th} position in one year. This does not diminish the value of reforms undertaken, but does point to three sources of concern: the budget deficit, the accumulated public debt and inflation. There is no doubt that the magnitude of these numbers is large, even if part of the reason is the change to a more transparent presentation of the government budget following established international standards.

Chapter 2 has provided a detailed explanation of the process of reform and how the government proposes to rectify these problems.

Last year's Report focused on industry as the "Engine of Growth," and this year we opted to focus on small and medium enterprises as being the backbone of the Egyptian economy, with a tremendous potential for expansion and job creation. The picture that emerges is that this sector, important as it is, is constrained by a disproportionate burden of regulations and difficulty of access to finance. The relative cost of doing business in this sector is probably higher than for large enterprises. This largely explains the lower ranking of Egypt according to the *Doing Business Report,* which in effect deals with small and medium enterprises, not large ones. The way out to realize the potential of this sector is through a two-fold strategy: easing access to finance and doing away with the cumbersome regulations that burden this sector. In addition, the consolidation of the institutional aspect by creating an entity that caters solely to the needs of this sector can only improve its performance.

Looking to the future, meeting the challenge of improving Egypt's competitiveness requires movement on several fronts but this movement has to be comprehensive, decisive and internally consistent. The major thrust of this Report is that the reforms that have been undertaken are paying off, but it is time to have a comprehensive competitiveness strategy. Piecemeal steps do not add up. It is time to take the next big step. A specific proposal here (in Chapter 4) is to introduce a mechanism of reform known as the "guillotine." This idea, which has been tested and proven in OECD countries as well as in other emerging economies, is very simple: to scrutinize all the rules and regulations that affect business by posing three questions: are they needed, are they legal and are they business-friendly. This process should build on the efforts already underway, especially the reform of the civil service and the reforms introduced by the Ministries of Finance, Investment and Trade and Industry.

It is hoped that this year's Report provides another building block in strengthening Egypt's competitiveness and deepening its culture.

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1. Egypt's Competitiveness Rankings

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Editors

1.1 EGYPT'S RANKINGS DECLINED TO JUST BELOW HALF OF ALL COUNTRIES LISTED ON THE GLOBAL COMPETITIVENESS INDEX

On the Global Competitiveness Index (GCI), Egypt fell from 52nd place in 2005 to 63rd in 2006, with a score of 4.09 (Switzerland, the highest-scoring country, had a score of 5.81, while Angola, with the lowest, had 2.50). Egypt ranked 8th out of the 13 Arab countries included in the rankings. Likewise, Egypt's rank on the Business Competitiveness Index (BCI), developed by Harvard University's Dr. Michael Porter, dropped from 71st to 76th. Egypt is now ranked in the lower half of all countries listed on the BCI. Notable improvements in primary education enrollments helped Egypt's score. However, this and other improvements were not sufficient to counteract the effect of a precipitous drop in macroeconomy rankings caused by increases in inflation, government budget deficits and overall government debt.

This chapter will present and analyze the rankings in ways that address five key questions:

1. Why are competitiveness rankings falling just as Egypt is recording high rates of economic growth, growing exports and increased foreign investment?

2. The Government of Egypt has been implementing a number of reforms recently, so why are the rankings going down instead of up?

3. Is Egypt's ranking, halfway down the list of countries, a fair indication of its competitiveness among countries of the world and why does this ranking differ so much from the Doing Business indicators of the World Bank?

4. Is enough being done to improve Egypt's competitiveness?

5. Finally, what practical recommendations can be given to Government policy makers and to others that wish to help Egypt improve its competitiveness?

To address these questions, this chapter presents the importance of competitiveness to Egypt, defines competitiveness, presents the results of the Global Competitiveness Index, analyzes the results of each of the 9 component pillars of that index and then cross-references the results to other key reports and rankings such as the Arab World Competitiveness Report, the Travel and Tourism Competitiveness Index (TTCI), the Business Competitiveness Index (BCI), the E-readiness rankings, the Network Readiness Index and the Doing Business Report of the World Bank. Taken together, these will give a comprehensive picture of the challenges facing Egypt.

1.2 THE IMPORTANCE OF COMPETITIVENESS TO EGYPT

Globalization is creating a new set of winners and losers in the world economy. China has become a leading beneficiary, with high rates of growth and impressive rates of poverty reduction. Countries which struggle to adapt to globalization are having a tougher time. The key to being one of the winners in globalization is competitiveness. Competitiveness is the key to achieving high rates of sustainable growth, increased employment, reduction in poverty and a stronger nation. Egypt must achieve greater competitiveness to catch up with the rest of the world economy. As the box below illustrates, Egypt has 1.15 percent of the world's population but only 0.33 percent of world GDP and 0.21 percent of world export markets. In ancient times, Egypt was arguably the world's most competitive country based on productivity of the workforce and technological innovation. It is increasingly urgent for Egypt to recover this tradition and take its rightful place in the modern world economy.

Competitiveness is the degree to which a country can compete in the global marketplace with products and services that meet international standards, while at the same time improving economic and living standards for its citizens. According to the world's leading expert on the subject, competitiveness is "the productivity with which a country utilizes its human, natural and financial resources." [1]

Each year the World Economic Forum prepares the world's leading report on global competitiveness, allowing countries to benchmark themselves against other nations as well as their own performance in previous years. *The Global Competitiveness Report 2006–2007* (GCR), released in September 2006, features two primary indexes: the Global Competitiveness Index (GCI) and the Business Competitiveness Index (BCI). [2] The former is very broad based while the latter focuses on the sophistication of business strategy and operations and the quality of the business environment. Both seek to analyze factors leading to current and future growth in income per capita. This report supplements these indexes with additional measures that confirm or at times seem to contradict the GCR, such as the World Bank's *Doing Business 2006–2007.*

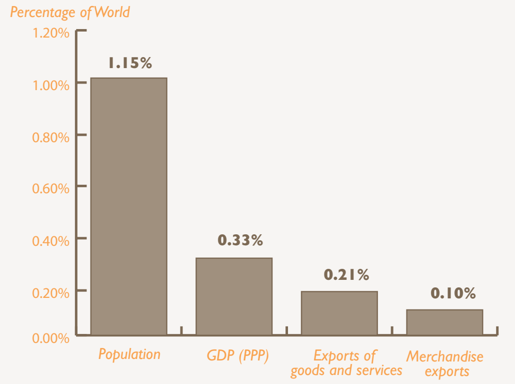
There are several methodological limitations that should be mentioned up front. First, the most recent developments in the economy will not be reflected in the country rankings because data for all countries is only available with a time lag. For example, macroeconomic data are from 2005, while data on health, education and telecommunications are from 2004. Second, the indexes rely on different types of data that include both hard data such as interest rates or life expectancy and soft data reflecting perceptions as expressed by the Executive Opinion Survey (EOS), which is implemented annually among executives of large and/or international companies based in Egypt. Finally, no single index or measurement can capture a country's performance, so where possible this report cross-checks the results with other data, rankings and indexes to confirm or balance the findings.

BOX 1.1: Population, GDP, and Exports: Egypt and the World

Egypt has yet to generate GDP and export levels in proportion to its population. As this figure shows, Egypt has 1.15 percent of the world's population, but only only 0.33 percent of world GDP, 0.21 percent of the world's exports of goods and services and 0.10 percent of merchandise exports."

Source: World Bank, 2007; data are for 2005 with analysis by J.E. Austin Associates.

FIGURE 1.1: EGYPT'S PERCENTAGE OF WORLD POPULATION, GDP AND EXPORTS



[1] Porter, Michael. "Building the Microeconomic Foundations of Prosperity: Findings from the Business Competitiveness Index." *Global Competitiveness Report 2005-2006*. World Economic Forum. p. 69.

[2] GCI, introduced in recent years, replaces and supersedes the earlier Growth Competitiveness Index. The GCI takes into account dimensions not considered in the earlier index.

1.3 EGYPT'S PERFORMANCE ON THE GCI

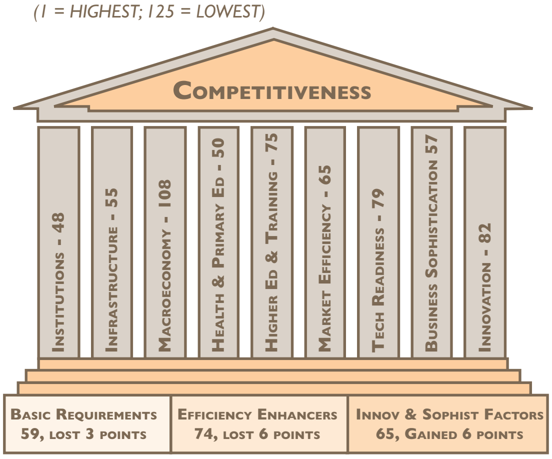
The Global Competitiveness Index (GCI) assembles the scores from 90 variables into nine "pillars" grouped into three sub-indexes: basic requirements (the pillars of institutions, infrastructure, macroeconomy, and health and primary education); efficiency enhancers (higher education and training, market efficiency, and technological readiness); and innovation factors (business sophistication and innovation).

The three sub-indexes are based on significant economic research that has found certain variables to be more or less important at various stages of economic development. The variables grouped in "basic requirements" tend to be more significant in explaining per-capita income growth for lower-income nations such as Egypt. "Innovation factors" are of higher importance to those nations that already have good infrastructure, education and other more basic elements in place. As a result, the GCR accords different weights to countries based on their stage of development. Egypt is classified as a factor-driven economy. [3] *For factor-driven economies, the basic requirements sub-index is seen as "critical" and given the greatest weight (50 percent) and efficiency enhancers are seen as very important and weighted accordingly (40 percent).*

1.3.1 Egypt Improved Its Performance in Health/primary Education, Market Efficiency, and Business Sophistication; and Dropped in Macroeconomy, Innovation, Higher Education/Training, and Technological Readiness

As mentioned earlier, on the GCI measure Egypt scored 63rd out of 125 countries in 2006 compared to 52nd out of 117 in 2005. Egypt ranked among the top 45 percent of countries in the 2005–2006 GCR but has now fallen to the lower half of countries. Figure 1.2 presents all of the pillar scores.

FIGURE 1.2: *EGYPT'S 2007 RANKINGS ON THE NINE PILLARS (1 = HIGHEST; 125 = LOWEST)*



Source: World Economic Forum. *Global Competitiveness Report 2006-2007.*

Compared to other emerging economies, Egypt did best on the pillars of institutions, health and primary education; its technological readiness and innovation scores were below par when benchmarked against them.

A more detailed comparison of Egypt's performance with that of other emerging economies may be useful at this stage.[4] Figure 1.3 gives a general view of where Egypt stands on the nine pillars of competitiveness compared to its main competitors, other emerging economies. Egypt's performance is shown relative to two groups of emerging economies, as defined by the Morgan Stanley Emerging Markets Index as of 2006.[5] The first group is the entire set of emerging economies (26 countries), while the second group includes only the less advanced emerging economies (it excludes Brazil, Israel, Mexico, South Africa, Korea, and Taiwan, which are classified by FTSE[6] as advanced emerging economies). Values in Figure 1.3 were normalized[7] for ease of comparison; in other words, a value of 1 was assigned to the best score achieved by any emerging economy. Egypt's score shows how far it has to go to achieve this highest score; for example, a score of .83 shows that Egypt attained a ranking 83 percent as high as the best-performing country among all emerging economies.

[3] For the GCI, countries are categorized into different stages of development according to per capita GDP. Countries with per capita GDP less than US$ 2,000 are at the factor-driven stage; from $3,000 to $9,000 countries are said to be at the efficiency-driven stage and with more than $17,000 in GDP per capita countries are at the innovation-driven stage. Countries with per capita income outside these ranges are in transition. Depending on the stage of development, the sub-indexes are given different weightings to arrive at the overall score. A factor-driven economy score is based on a weighting of 50 percent for basic requirements, 40 percent for efficiency enhancers, and 10 percent for innovation and sophistication factors. Efficiency-driven countries' weightings are 40 percent, 50 percent, and 10 percent respectively, and innovation-driven countries are weighted at 30 percent, 40 percent, and 30 percent.

[4] For this analysis Nihal Maghrabel draws on: Refaat, Amal. 2007. *Egypt's Global Competitiveness: Unlocking the 2006-2007* Report. Policy View Point no. 20. January. The Egyptian Center for Economic Studies.

[5] The whole set of emerging economies includes Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey, and Venezuela.

[6] FTSE is an independent company owned by the Financial Times and the London Stock Exchange. Its sole business is to create and manage indexes on an international scale.

[7] To visualize where Egypt stands on the different pillars of competitiveness and how far it has gone along the route covered by other emerging economies, Egypt's score on each pillar, Z, was normalized using the formula:

$$\acute{Z}E = \frac{Z_E - min\ Z}{max\ Z - min\ Z}$$

where

$\acute{Z}_E$ = normalized Z for Egypt

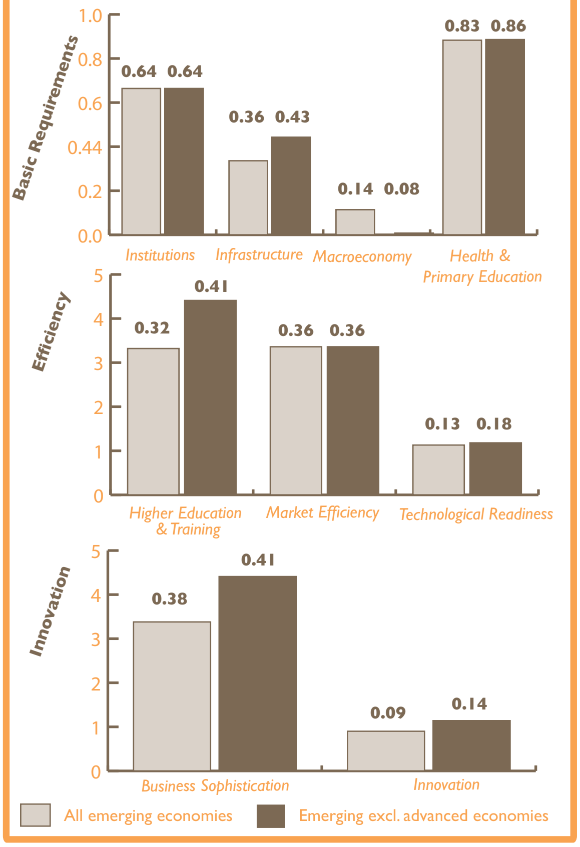
Z_E = Egypt's value of variable Z

Min Z = min value of Z in the group of emerging economies

Max Z = max value of Z in the group of emerging economies

The normalized values are indicators of the distance Egypt covered (Z_E min Z) from the total route it has to cover (max Z – min Z). If Egypt's value is at the minimum, the normalized value of the measure will be 0 and if it has attained the maximum value, the normalized value will be 1.

FIGURE 1.3: *EGYPT'S NORMALIZED VALUES ON THE NINE PILLARS OF THE GCI*



Source: Refaat, Amal. January 2007. "Egypt's Global Competitiveness: Unlocking the 2006–2007 Report." Policy View Point no. 20. The Egyptian Center for Economic Studies.

Compared to other emerging economies (whether the entire group or the less-advanced subgroup) Egypt performed relatively well on health and primary education and to a lesser extent on institutions. It lies at the low end as regards macroeconomy, innovation and technological readiness. As regards infrastructure, higher education and training, market efficiency and business sophistication, Egypt has traveled about 30–40 percent of the way covered by other emerging economies. If advanced emerging economies are excluded, Egypt's relative position improves marginally on health and primary education, infrastructure, technological readiness, higher education and training, business sophistication and innovation, remains unchanged on institutions and market efficiency and deteriorates on the macroeconomy pillar of competitiveness.

Egypt's improvement relative to all countries on the important pillar of health and primary education was boosted by a notable increase in primary education enrollment rates. The Government should be commended for its effort to expand primary school enrollment, an effort which is now being recognized in the competitiveness rankings.

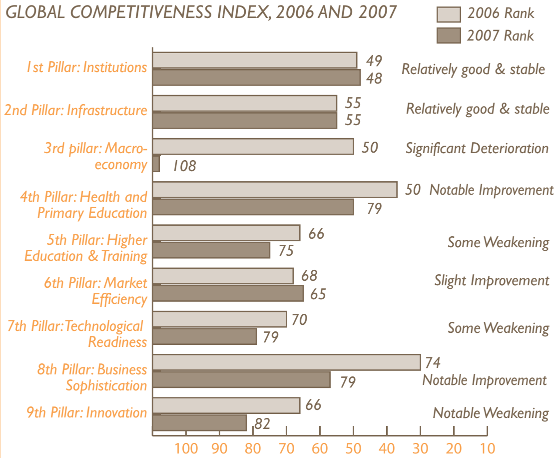
The main factor bringing down Egypt's overall score was a sharply reduced performance in the macroeconomy pillar. This decline was driven by an increase in the recorded budget deficit, high overall levels of government debt, worsening inflation and relatively high interest rate spreads between deposit rates and loan rates. This is a particularly troubling development in light of last year's performance: at a rank of 50 in 2006, Egypt had climbed impressively from a score of 81st in 2005, supporting the contention that the macroeconomic landscape was under control.

Chapter 2 indicates the reasons for this reversal in macroeconomic rankings. To some extent, Egypt is now reporting its budget deficit more honestly and transparently, having now adopted IMF reporting methods. Budget deficits in prior years may have been understated. Causes of the budget deficit include a very large government civil service payroll (over 5 million employees), food subsidies and energy subsidies. The need to preserve social and political stability raises the question as to whether the budget deficit is needed to protect the poor and to preserve social peace. While this is a fair question, one must also ask whether one can protect the poor with a social safety net in a more direct way through "smart subsidies." After all, some energy subsidies disproportionately benefit those who own cars rather than the very poor who do not own cars and may not even travel much. Is it appropriate to differentiate between subsidies that benefit the consumer and those that benefit the producer? Is it appropriate to identify who benefits from which subsidies, and set priorities accordingly? If petroleum subsidies are disproportionately enjoyed by middle and upper income groups who can afford cars, reconsideration may be in order to ensure that government subsidies better target lower income groups while still protecting those who rely on mass transit. And is there a way to make the civil service more productive and to foster a gradual change in the culture of employment so that young people esteem a career in the private sector as highly as that in the public sector? Can the civil service itself see its mission as stimulating investment and economic activity through a service-oriented approach to the productive sector?

Beyond the macroeconomic area, there were also declines in other scores, such as those related to higher education. Figure 1.4 shows a comparison of Egypt's performance on each of the nine pillars from the previous year's GCR.

Within the Efficiency Enhancers sub-index, market efficiency (Pillar 6) has improved overall, specifically the ease in doing business. The number of procedures to start a business has dropped from 13 to 10, and the time to start a business has dropped from 43 days to 34. But are these modest reforms and improvements enough to boost Egypt's competitiveness significantly in the long term? As shown in section 1.3.2.2, survey results indicate a higher negative perception of the costs on the economy imposed by agricultural policy. Labor market efficiency also received a declining score. The quality of higher education and training received lower scores this year as well, as did the technological readiness of the country.

FIGURE 1.4: *EGYPT'S RANKINGS ON THE NINE PILLARS OF THE GLOBAL COMPETITIVENESS INDEX, 2006 AND 2007*



Source: WEF.

1.3.2 Egypt's Performance on Each of the Nine Pillars

This section provides a detailed look at Egypt's performance on each of the pillars, revealing relative advantages and disadvantages,[8] and explores the reasons behind significant improvements and declines.

1.3.2.1 Basic Requirements (Pillars 1–4): Egypt Moves Upward on Health and Primary Education but Downward on Macroeconomy

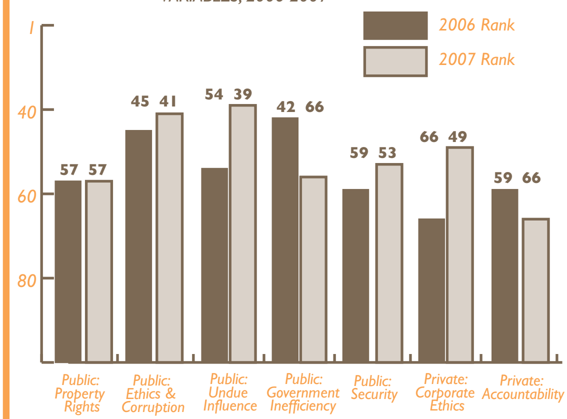
Pillar 1 (Institutions): Similar Overall to Last Year

Pillar 1 rankings on institutions are divided into public and private. Public institutions come in at almost the same score as the previous year (49th last year, 48th in 2007). However, within this category there is a definite improvement in the level of confidence in terms of diversion of public funds (up from 56th to 41st place) as well as use of undue influence (from 54th to 39th). Also, perception has improved on the business costs associated with crime and violence. However, the perceived business costs of terrorism have increased and Egypt ranks 105 out of 128 countries on this variable.[9] Egypt received poorer scores this year relative to government inefficiency, bureaucratic red tape and waste and wasteful government expenditure.

A similar story emerges when one looks at private institutions (from 62 to 61). While there has been a significant improvement in corporate ethical behavior (from 66 to 49), there has been a decline in accountability (59 to 66) — corporate boards have become less efficacious and auditing and reporting standards have become weak.

Overall, public and private institutions have the advantage of being technocratic rather than corruption-ridden; however, efficiency is lacking.

FIGURE 1.5: *EGYPT'S RANKING OF PILLAR 1 (INSTITUTIONS) VARIABLES, 2006-2007*



Source: WEF.

[8] Any individual variable ranked lower than 63 (Egypt's GCI rank) is considered as a disadvantage while any variable ranked higher than 63 is considered as an advantage.

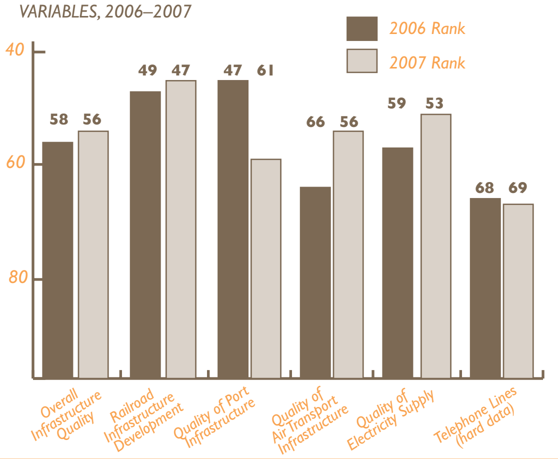
[9] *Arab World Competitiveness Report 2007.*

Pillar 2 (Infrastructure): Same Overall as Last Year

Egypt's overall infrastructure ranking remains the same as last year. However, while quality of air (up from 66 to 56) and railroads (from 49 to 47) seem to have improved, port infrastructure has declined (47 to 61). This becomes significant when one takes into account that 90 percent of the country's trade (both exports and imports) is handled at ports. According to a World Bank report,[10] Egyptian ports are saddled with infrastructural inefficiencies, old institutional structures, high logistic costs and unrealistic tariffs.

In comparison to other Arab countries however, Egypt's infrastructure is considered among the better ones,[11] and if port quality were to improve along with continuing improvements in other transport means, this could well become one of the country's competitive strengths.

FIGURE 1.6: EGYPT'S RANKING ON PILLAR 2 (INFRASTRUCTURE) VARIABLES, 2006–2007



Source: WEF.

Pillar 3 (Macroeconomy): A Precipitous Decline

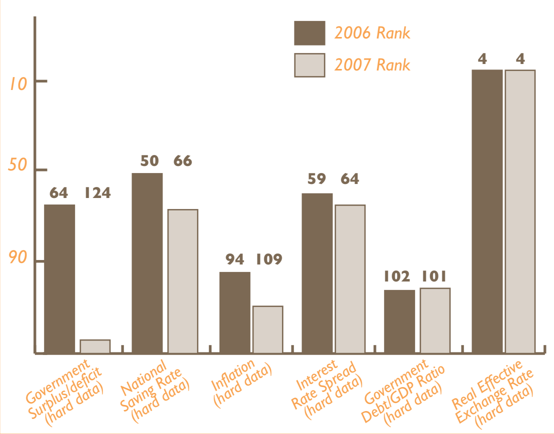
By far one of the most significant reasons for the decline in the country's overall competitiveness has been the decline in its macroeconomic conditions, a subject which will be covered in more depth in Chapter 2 of this Report. The macroeconomy index has dropped from 50 to 108 in one year, driven primarily by a spiraling government deficit (a drop from 64th to 125th place). This has been compounded by a decline in the national savings rate and increasing inflation and interest rate spread.

The country's deficit "remains an area of concern" according to the World Bank,[12] and the recent *Arab Global Competitiveness Report 2007*[13] notes that Egypt has "good institutions and infrastructure but one of the highest deficits in the world."

The World Bank also notes that risks stem from large energy subsidies (about 8 percent of GDP in FY05), significant banking sector restructuring costs, and transition costs of forthcoming pension reform. It is important to note, however, that the government has taken a number of policy actions towards meeting this challenge — one being the increase in prices across several petroleum products that was estimated to reduce the subsidy costs by 1 percent of GDP.

Such drops in macroeconomic parameters can have important cascading effects in the economy, ultimately leading to a drop in inward FDI, loss of domestic and international consumer and investor confidence and distortions in market efficiency. Hence the macroeconomic concerns must be addressed quickly and effectively.

FIGURE 1.7: EGYPT'S RANKING ON PILLAR 3 (MACROECONOMY) VARIABLES, 2006–2007



Source: WEF.

[10] "Port Sector Development Project Concept Note." 2005. World Bank.

[11] *Arab Global Competitiveness Report 2007* Chapter 1.

[12] Country Brief–Egypt, World Bank.

[13] *Arab Global Competitiveness Report 2007* Chapter 1.

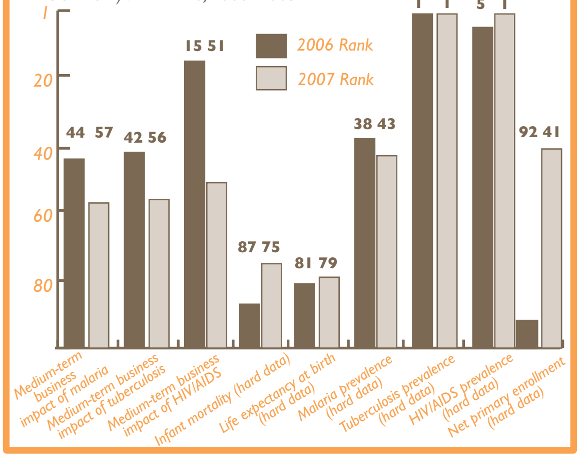
1.3.2.2 Efficiency Enhancers (Pillars 5–7): Education and Technological Readiness Decline

Pillar 4 (Health and Primary Education): Significant Improvements

Egypt has done very well on health and primary education since last year, with most parameters showing very significant improvements. The greatest improvement is in net primary enrollment which shows an increase in rank from 92 to 41, supported by a significant improvement in primary enrolment rates. Primary enrollment is now approaching the best scores for the Middle Eastern region and for lower middle income countries.[14]

In health, infant mortality has dropped (raising Egypt's rank from 87th to 75th). Life expectancy has also increased to 68 years.

FIGURE 1.8: *EGYPT'S RANKING ON PILLAR 4 (HEALTH & PRIMARY EDUCATION) VARIABLES, 2006–2007*



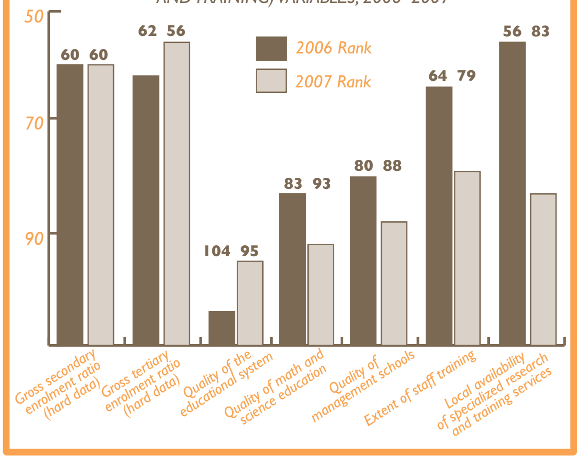
Source: WEF.

Pillar 5 (Higher Education and Training): A Decline in Quality

Egypt shows weakness in its higher education and training. While the quantity of higher education seems to be almost the same as last year, survey results on the quality of education declined and Egypt moved down from 89th to 109th place. This decline has been across the board: in the quality of overall educational system, in math, sciences and management schools. According to World Bank reports, quality of education suffers due to a number of factors: low compensation for teachers, low private sector participation and low community participation all adversely affect the nature of education imparted.[15]

Although the government should be lauded for the several education reform initiatives such as community schooling and "education for all," continued weakness in higher education and lack of academic relevancy to the productive sector acts as a major drag on competitiveness. Survey after survey in Egypt has indicated that this needs to be addressed urgently.

FIGURE 1.9: *EGYPT'S RANKING ON PILLAR 5 (HIGHER EDUCATION AND TRAINING) VARIABLES, 2006–2007*



Source: WEF.

[14] World Bank. *World Development Indicators 2006.*

[15] Country Assistance Strategy for Egypt. 2005. World Bank.

Pillar 6 (Market Efficiency): A Slight Overall Improvement

While there has been a marginal improvement in market efficiency (68th to 65th place), this hides the movements in the different sectors: goods, labor and financial markets. The goods market is becoming more efficient and is supported by a more sophisticated financial market, but the labor market shows increasing signs of inflexibility.

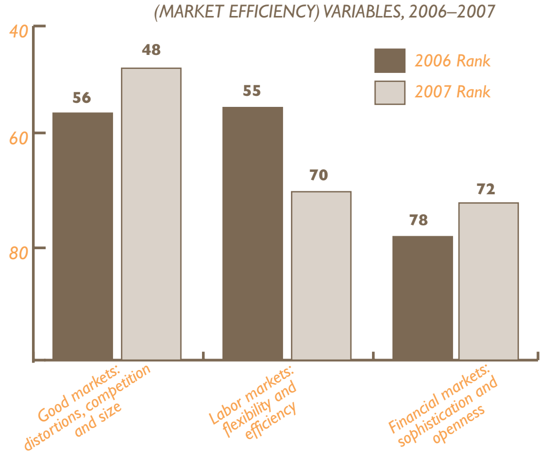
The **goods market** has become more efficient (56th to 48th). Improvements included fewer procedures and less time to start a business along with improvement in taxation. Survey feedback on the cost of the country's agricultural policy resulted in a drop in Egypt's rankings from 41st to 90th place, an important indicator given that 15 percent of Egypt's GDP comes from agriculture.[16]

Labor market competitiveness dropped from 55th to 70th position. This is largely because of perceived inflexibility in labor markets, which contributes to the slow drop in unemployment despite growth in GDP.[17] Unemployment is now reported to be less than 10 percent, but this almost certainly understates the problem when underemployment is taken into account. Rigidity of the labor market is being seen as one of the biggest challenges facing the economy, according to the World Bank's Doing Business indicators.[18] On a scale of 1 to 100, Egypt scored 53 on the labor market rigidity index. MENA (Middle East and North Africa) as a whole scored better at 35.8.[19] Within this index, Egypt had the worst possible score (100) on the rigidity in firing workers.

Everyone agrees that it is important to protect the rights of workers. In fact, fair treatment of workers is becoming a major precondition for exporting to the global market, which increasingly demands that fair labor standards be observed. However, when the ability to terminate employees is extremely cumbersome or unnecessarily litigious, it leads to a great reluctance to hire people making it more difficult for people to find jobs and leading employers to prefer capital intensive investment to labor intensive investment. Finally, brain drain and inadequate reliance on professional managers is also reported to be a problem.

The efficiency of the **financial markets** has improved. Access to equity has improved from 62nd to 54th place. However, the overall scenario continues to be one of weak financial markets, with inefficient channeling of scarce resources into profitable investments. Moreover, growth of the private sector is curbed by lack of capital. Access to loans, equity capital and venture capital has remained weak.

FIGURE 1.10: *EGYPT'S RANKING ON PILLAR 6 (MARKET EFFICIENCY) VARIABLES, 2006–2007*



Source: WEF.

[16] CIA Factbook.

[17] *Arab Global Competitiveness Report 2007.*

[18] Doing Business Dataset. 2006. World Bank.

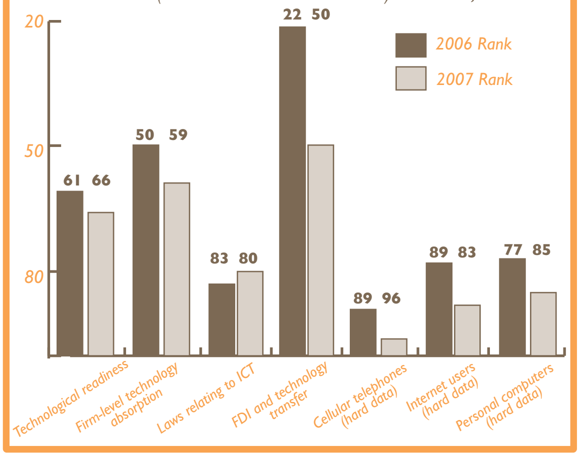
[19] The lower the index score, the better the performance.

Pillar 7 (Technological Readiness): A Nine-Place Decline

Egypt has slipped in its rankings on technological readiness from 70 to 79, driven by a decline across most indicators, including a drop in technology transfer (from 22nd to 50th).

This lack of performance has been captured across several indicators; the Economist Intelligence Unit e-readiness Index for 2006 puts Egypt at 55th place out of 68 ranks. The Network Readiness Index of the *Global Information Technology Report* ranked Egypt at 77th place out of 122 countries, down from 63rd rank the year before (out of 115 countries).[20] Despite Government focus on this area, Egypt's investment in ICT as a percent of GDP is low compared to others in the Arab region (2.37 percent against 2.87 percent) and much less than the global average of over 6 percent.[21]

FIGURE 1.11: EGYPT'S RANKING ON PILLAR 7 (TECHNOLOGICAL READINESS) VARIABLES, 2006–2007



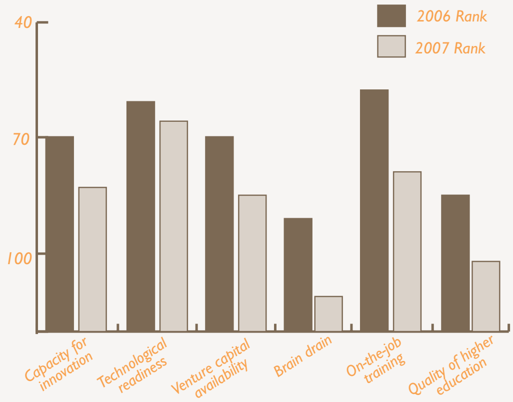
Source: WEF.

BOX 1.2: Egypt: Progress Towards a Knowledge Economy?

A number of interlinked phenomena that fall under different GCI pillars impact Egypt's ability to move toward a knowledge economy: the quality of higher education, brain drain, and availability of venture capital, among others. Figure 1.12 shows Egypt's performance on select representative variables; the overall decline indicates that policy makers must develop coherent strategies that consider each of these issues if Egypt's economy is to become knowledge-driven.

Source: WEF.

FIGURE 1.12: EGYPT'S RANKING ON SELECT FACTORS RELATED TO A KNOWLEDGE-DRIVEN ECONOMY, 2006–2007



[20] *Global Information Technology Report*. 2007. World Economic Forum.

[21] *Arab Global Competitiveness Report 2007*. Chapter 2.3.

BOX 1.3: E-readiness Rankings

According to the Economist Intelligence Unit e-readiness rankings Egypt was in 55th place out of 68 countries in 2006. Table 1.1 shows Egypt's rank and score relative to other emerging economies. Egypt's score is lower than the emerging country average (5.14), as it scores 4.14, but better than its score last year, which was 3.9.

Table 1.1: 2006 E-readiness Rankings

Country	Rank	Score
Korea, Republic of	18	7.9
Israel	22	7.59
Taiwan, China	23	7.51
Chile	31	6.19
Poland	34	5.76
South Africa	35	5.74
Malaysia	37	5.6
Brazil	41	5.29
Turkey	45	4.77
Venezuela	48	4.47
Colombia	51	4.41
Russian Federation	52	4.3
India	53	4.25
Jordan	54	4.22
EGYPT	55	4.14
Philippines	56	4.04
China	57	4.02
Indonesia	62	3.39
Pakistan	67	3.03
Mexico	39	5.3
Argentina	42	5.27
Thailand	47	4.63

Source: The Economist Intelligence Unit. 2007. Global Technology Forum.

Internet penetration has grown rapidly in Egypt since 2000. Estimates by the Ministry of Communications and Information Technology put the number of users at 6.4m in January 2007, up from 5.1m in January 2006. Growth has been encouraged by government-sponsored "Free Internet" services. According to the *Global Information Technology Report 2006–2007*, the Network Readiness Index (NRI) measures the propensity of countries to leverage the opportunities offered by ICT for development and increased competitiveness. This Index examines the preparedness of countries to use ICT effectively on three dimensions: the general business, regulatory and infrastructure environment for ICT; the readiness of the three key stakeholders — individuals, business and governments — to use and benefit from ICT; and their actual usage of the latest information and communication technology available. Egypt's rank is the 77th of 122 countries, with a score of 3.44, lower than the 25 emerging economies average score, which is 3.98. However, efforts were exerted to improve Egypt's ranking. These efforts include the issuance of Intellectual Property Rights Law and the Electronic Signature Law.

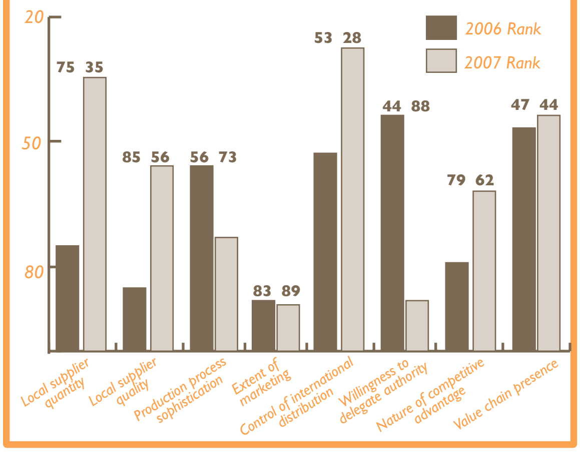
1.3.2.3 Innovation Factors (Pillars 8–9): Mixed Results and Declines in Innovation

Pillar 8 (Business Sophistication): Improvement in Supporting Industries

The country shows a marked improvement in business sophistication (74 to 57) which has been possible only due to improvement in the network of its supporting industries. This success becomes even more apparent when weighed against a decline in rankings of the other parameters — sophistication of firm's operations and strategy. Production processes do not seem to be improving and there is continued reluctance by business owners to delegate authority.

These shifts in the microeconomic foundations of firms are echoed in Egypt's low score on the BCI, where Egypt ranked 23rd among 26 emerging economies, ahead of only Russia, Venezuela and Morocco.

FIGURE 1.13: EGYPT'S RANKING ON PILLAR 8 (BUSINESS SOPHISTICATION) VARIABLES, 2006–2007



Source: WEF.

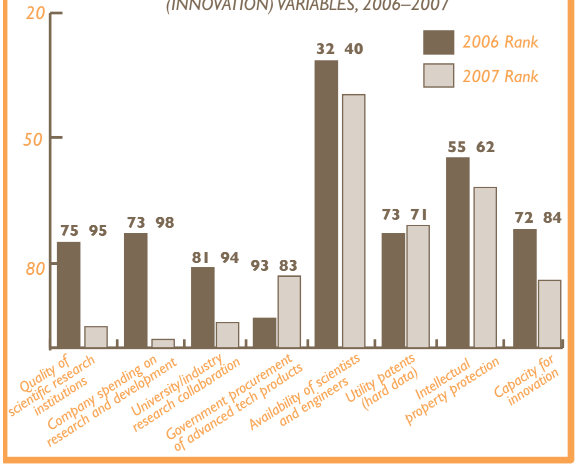
Pillar 9 (Innovation): Declining Performance

Egypt has slipped considerably in its ranking on innovative capacity (from 66th to 82nd place). There has been a decline across most parameters: company spending on R&D, declining quality of research institutions and IPR. There were also declines in the availability of scientists and engineers and the number of utility patents.

While not neglecting basic skills and vocational training, Egypt needs to focus policy on its innovative capacity including the quantity, quality and relevancy of education at all levels. It must also create better linkages and promote linkages between its research institutions and the productive sector if Egypt is to move towards a knowledge economy.

It is interesting to note that the *Arab World Competitiveness Report* survey on potential R&D hubs in the Arab region ranks Egypt second after the UAE. While Egypt places a distant second (42 percent of respondents identify the UAE as having the greatest potential, compared to 10 percent for Egypt), the point remains that the country is seen to have potential.

FIGURE 1.14: EGYPT'S RANKING ON PILLAR 9 (INNOVATION) VARIABLES, 2006–2007



Source: WEF.

1.3.3 Egypt's Ranking Relative to 13 Arab Countries: 8th Place

This year, the GCI included 13 Arab countries.[22] The highest ranked of these were Tunisia, United Arab Emirates, and Qatar. Within the region, Egypt was in 8th place.

The *Arab World Competitiveness Report 2006–2007* identifies public and private institutions and a less corrupt bureaucracy among Egypt's strong points in comparison to other Arab countries, with good transport, energy and communications infrastructure. Although high primary school enrollment rates give Egypt's ranking a boost, quality of education remains low. Efficiency of goods, labor and financial markets remains low and the potential of technology and innovation remain underutilized. Table 1.2 gives an overview of Egypt's performance relative to other Arab nations.

As noted in the *Arab World Competitiveness Report 2007,* however, a straightforward ranking of the Arab countries' performance on the GCI obscures the diversity of their performance in relation to their development trajectories. For example, when countries are grouped according to their stage of development,[23] the picture is somewhat different. Among the 48 countries classified as at stage 3, Egypt is a respectable 4th, and is the highest ranked stage-3 Arab country (followed by Morocco, Syria and Mauritania, in that order). However, Egypt is a relatively high performer only when grouped with low-income countries. Egypt's aspiration is to become a high performing economy able to exercise economic and political leadership regionally and globally. Table 1.3 shows the breakdown of Arab countries' performance on each of the components that are combined to produce the macroeconomy ranking. Only Mauritania ranked lower among Arab countries on this indicator.

Table 1.2: Performance of Arab Countries on the 2007 GCI

Country	GCI rank among Arab countries	Rank among all 125 countries	Country strongest areas of performance*	Weakest areas of performance*
Tunisia	1	29	Institutions, primary education, business sophistication	Infrastructure, financial markets
United Arab Emirates	2	32	Macroeconomy, transport infrastructure, public and private institutions, labor markets	Educational system, market efficiency, innovation
Qatar	3	39	Macroeconomy, education	Infrastructure, business sophistication
Oman	4	44	Macroeconomy, institutions, labor efficiency	business sophistication, innovation
Kuwait	5	45	Macroeconomy	Education, innovation
Bahrain	6	50	Macroeconomy, health and primary education, public institutions, infrastructure	Higher education
Jordan	7	54	Institutions	Macroeconomy, labor markets, technological readiness
Egypt	8	65	Institutions, infrastructure	Macroeconomy, market efficiency
Morocco	9	72	Infrastructure, market efficiency	Education
Algeria	10	78	Macroeconomy, health	Market efficiency, technological readiness
Libya	11	82	Macroeconomy	Infrastructure, education
Syria	12	83	Relatively low corruption, infrastructure	Macroeconomy, market efficiency
Mauritania	13	118	Institutions	Macroeconomy

* These characterizations are based on summarized data; in some cases performance on particular aspects of a category is at variance with overall performance in that category.

Source: World Economic Forum. 2006. *Arab World Competitiveness Report 2007.*

[22] Algeria, Bahrain, Egypt, Jordan, Kuwait, Libya, Mauritania, Morocco, Oman, Qatar, Syria, Tunisia, and the United Arab Emirates.

[23] In the first group (the factor-driven stage) are Egypt, Morocco, Syria and Mauritania. In the next group (which includes countries in transition from stage 1 to stage 2; stage 2; and in transition to stage 3) are Tunisia, Oman, Jordan, Libya, and Algeria. Stage 1 (innovation-driven) countries are United Arab Emirates, Qatar, Kuwait and Bahrain.

Unlike the economies of Libya, Algeria, Kuwait and others in the region, Egypt cannot rely primarily on oil and gas exports to fuel its growth. It must turn to other potential areas of advantage to move it upward from the factor-driven stage.

Manufacturing is one key area for growth. However, it seems that much of Egypt's industrial growth has been distorted towards capital-intensive investment rather than labor-intensive investment because of subsidized energy on the one hand and inflexible labor markets on the other. The focus on special economic zones and the recent upsurge in apparel exports are an attempt to address improving Egypt's performance as a potential manufacturing location based on a large pool of potential workers.

Services represent another area for potential growth and job creation in Egypt. Given its unsurpassed cultural and historic resources, Egypt has relied heavily on tourism. The *Arab World Competitiveness Report* addresses Egypt's competitiveness in this industry in its first tourism-related report. Travel and Tourism are growing dramatically worldwide, but the Arab region has yet to capture a significant fraction of international tourist arrivals. Egypt holds its own in this category; according to UNWTO figures, only Saudi Arabia (which attracts in the neighborhood of 2 million Hajj pilgrims yearly) receives more visitors. At the low end, Kuwait and Libya receive 91,000 and 149,000 tourist arrivals annually; by contrast Egypt receives over 8.2 million and Saudi Arabia 9.1 million visitors each year.

Even so, Egypt posts a surprisingly mediocre performance in the World Economic Forum's newly launched "Travel & Tourism Competitiveness Index" (TTCI). The first-ever TTCI, released in March 2007, measured the T&T competitiveness of 124 economies, examining wide-ranging variables that impact the T&T sector. In a manner analogous to the GCI, the TTCI incorporates 13 pillars grouped into three sub-indexes: the T&T regulatory framework; the T&T business environment and infrastructure; and human, cultural, and natural resources. Egypt ranked 58th overall, with correspondingly modest ranks of 50, 60, and 68 in the respective sub-indexes. It was outperformed by UAE (which ranked 18th), Tunisia (34th), Qatar (36th), Jordan (46th), Bahrain (47th), and Morocco (57th), but did better than Kuwait (67th) and Algeria (93rd). Egypt's lagging tourism infrastructure (hotel room availability, telephone and Internet penetration, availability of ATMs) contributed to this lackluster showing.

Nonetheless, there is great potential for Egypt to improve its tourism competitiveness scores in future years. Its strengths include many World Heritage sites, excellent price competitiveness, and impressive government initiatives to jumpstart the tourism industry, not just through external steps such as creating favorable visa policies and guaranteeing a strong Egyptian presence at major tourism trade events but also by energizing the country's human resources, through a campaign aimed at educating the populace and rewarding exemplary performance in the tourism field. However, the tourism industry will have to focus on workforce development and improved strategies to capture higher value and to generate a desire among tourists to return to Egypt.

Table 1.3: Arab Country Rankings on Macroeconomy (Pillar 3) Variables, 2007

Country	Pillar 3 Ranking	Break out of Pillar 3 Variables					
		Real effective exchange rate	Government debt/GDP ratio	Interest rate spread	Inflation	National savings rate	Government surplus/ deficit
Libya	1	1	2	13	34	3	2
Algeria	2	13	28	73	13	4	6
Kuwait	3	43	12	42	60	1	1
Qatar	4	73	25	40	47	2	4
UAE	5	41	8	44	80	8	3
Oman	6	16	10	36	19	36	7
Bahrain	13	25	n/a	80	39	25	10
Tunisia	39	20	70	22	22	50	78
Syria	61	21	73	24	90	61	92
Morocco	81	45	85	87	8	29	116
Jordan	106	40	93	53	56	124	112
Egypt	111	5	104	67	112	69	127
Mauritania	123	46	106	n/a	114	119	122

Source: WEF. Arab World Competitiveness Report 2007.

1.4 EGYPT FALLS ON THE BUSINESS COMPETITIVENESS INDEX

Egypt ranked 76th out of 121 countries on the Business Competitiveness Index (BCI), developed by Professor Michael Porter, falling five rankings from last year and confirming a general downward trend. Both the sophistication of company operations (76th place) and strategy and the quality of the national business environment (74th) are relatively low.

The BCI reports on both the quality of the business environment and on the sophistication of business strategy and operations. While the BCI uses a combination of survey and hard data, the core of this year's index draws on the survey results.[24]

BOX 1.4: ECES Business Barometer

The Egyptian Center for Economic Studies (ECES) publishes the Business Barometer (BB) twice a year. This survey covers 320 large firms from the manufacturing, construction and tourism sectors and captures specific firm-level results during the last six months along with expectations for the next six months. The January 2007 issue of the BB indicated that the majority of firms are confident about economic growth and they anticipate stable or higher production, sales, investment and employment. The survey also pinpointed the beginning of a recovery for the tourism sector. Firms expect positive economic growth. Weak demand and inadequate access to credit were reported as the two main constraints facing firms' expansion.

Source: The Egyptian Center for Economic Studies. January 2007. Business Barometer. Issue no. 18.

1.5 IN THE DOING BUSINESS REPORT 2007 EGYPT CONTINUES TO RANK AMONG THE LOWEST-PERFORMING COUNTRIES

While Egypt ranks near the middle of all countries in the GCI, it ranks close to the bottom in the World Bank's Doing Business Report 2007 *(DB 2007). According to this report, Egypt's ease of doing business rank is 165 out of 175 countries compared to its 141st place out of 155 countries according to last year's report.*[25] *Why is there this discrepancy? The GCI reflects the business environment as seen by large firms and multinational corporations, whereas the DB ranking is focused on challenges likely to be most relevant to small businesses, medium sized business and domestic firms. Doing Business also focuses on specific parameters affecting the ease of doing business rather than the many aspects of competitiveness.*

Given the importance of small business to economic growth, Chapter 3 of this Report takes an in-depth look at the current business environment for small businesses.

Table 1.4 presents Egypt's rank on the ten factors affecting doing business. It indicates that dealing with licenses, getting credit and enforcing contracts are the most constraining factors of doing business in Egypt. These results are in line with those of the GCI's Executive Opinion Survey (see Figure 1.15), which indicates that inefficient government bureaucracy and access to finance are the most problematic factors for doing business in Egypt. Although employing workers and an inadequately educated workforce indicate two different problems, these two factors used by the World Bank and WEF both highlight labor market deficiencies. Tax administration is still a major impediment for business in Egypt, according to the two reports, despite recent tax reforms.

[24] The 2006 EOS gathered data from more than 10,000 senior business leaders in 121 countries. Egypt's survey is conducted by the Egyptian Center for Economic Studies.

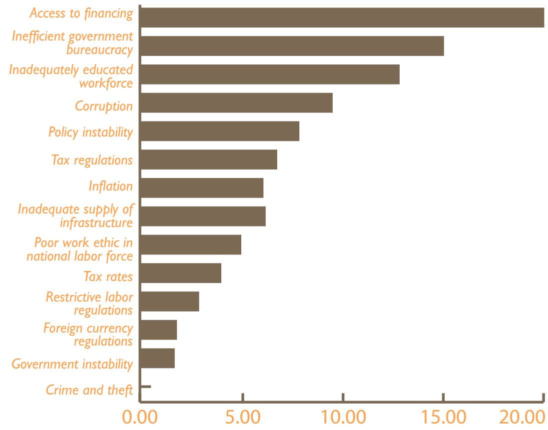
[25] In the 2006 Report, the rankings from 2005 have been recalculated to include the 20 countries added in 2006. When this is done, Egypt ranks 165 out of 175 countries in both years.

Table 1.4: Egypt's Rank on the Factors Determining Doing Business

Factor	Rank (out of 175 countries)
Dealing with licenses	169
Getting credit	159
Enforcing contracts	157
Employing workers	144
Paying taxes	144
Registering property	141
Starting a business	125
Closing a business	120
Protecting investors	118
Trading across boards	83

Source: World Bank. 2006. *Doing Business Report 2007.*

FIGURE 1.15: THE MOST PROBLEMATIC FACTORS FOR DOING BUSINESS IN EGYPT (% OF RESPONDENTS IDENTIFYING EACH FACTOR)



Source: Executive Opinion Survey in the World Economic Forum's *Global Competitiveness Report 2006–2007.*

Egypt's low performance on business sector competitiveness is a reflection of the inadequate nature of reforms. Over the past few years there have been attempts to reduce barriers to market entry and exit and to improve the tax system, but it is evident that improving the regulatory environment requires more than piecemeal reforms at different points in time. Also, the majority of firms in Egypt are still underdeveloped in their operations and strategies and their export readiness is very limited despite the multiple business support programs. This suggests the need for bolder reforms.

Egypt's scores from the *Doing Business Report 2006* and those of some comparator countries are noted in Table 1.5.

While the GCI shows that economic life is relatively manageable for large and international companies in Egypt, the Doing Business report shows that life is really quite difficult for Egyptian owned businesses, especially small and medium sized businesses that are less able to manage the red tape, get access to finance and deal with the many barriers to running a business that exist in Egypt.

Table 1.5: Performance of Egypt and Comparators on the Most Problematic Factors of Doing Business

		Egypt	Jordan	Morocco	Mexico	Chile	Hungary	Turkey	Czech Rep.	Poland	Thailand	Malaysia	Indonesia
Access to financing	Strength of Legal Rights Index (0–10)	1	5	3	2	4	6	3	6	4	5	8	5
	Depth of Credit Information Index (0–6)	2	2	1	6	6	5	5	5	4	5	6	2
Tax Regs.	Payments (Number)	41	26	28	49	10	24	18	14	43	46	35	52
	Time (Hours Per Year)	536	101	468	552	432	304	254	930	175	104	190	576
Tax Rates	Total Tax Payable (% of Gross Profit)	50.4	31.9	52.7	37.1	26.3	59.3	46.3	49	38.4	40.2	35.2	37.2
Inefficient Bureaucracy	Procedures to Start a Business (Number)	10	11	6	8	9	6	8	10	10	8	9	12
	Time to Start a Business (Days)	19	18	12	27	27	38	9	24	31	33	30	97
	Procedures to Obtain a License (Number)	30	16	21	12	12	25	32	31	25	9	25	19
	Time to Obtain a License (Days)	263	122	217	142	171	212	232	271	322	127	281	224
	Procedures to Register Property (Number)	7	8	4	5	6	4	8	4	6	2	5	7
	Time to Register Property (Days)	193	22	46	74	31	78	9	123	197	2	144	42

Source: World Bank.

1.6 CONCLUSION

Following the presentation and analysis of Egypt's performance on the GCI and other important indexes related to competitiveness, it is important to address the five questions posed at the start of this chapter. The point of this report is not to give definitive answers but to raise issues important to an informed and productive private-public dialogue. However, some possible answers to the questions are presented below in hopes that these may stimulate a well intentioned and positive debate on how to most rapidly reposition Egypt as one of the most competitive economies in the region.

1. Why are competitiveness rankings falling just as Egypt is recording high rates of economic growth, growing exports and increased foreign investment?

Egypt's impressive economic growth is to be welcomed and one hopes that this impressive growth can be maintained. Chapter 2 will analyze the sources of this growth in more detail. However, important elements of this growth have been fueled by improved prices for Egypt's subsoil assets, the buoying effect of regional Arab prosperity resulting in investment in Egypt and remittances from abroad. Export growth has been driven by natural resource-related and energy-related factors more so than labor-intensive manufactures. And foreign investment has benefited from the sale of the third wireless telecom license. These causes of growth may or may not be sustainable. Many of the underlying causes of the previous economic underperformance remain. The fall in rankings are mainly caused by reversals in macroeconomic indicators. The good news is that these should be subject to improvement, especially given the overall reputation of high competence enjoyed by the Minister of Finance and the broader economic team.

2. The Government of Egypt has been implementing a number of reforms recently, so why are the rankings going down instead of up?

While it is true that many reforms and improvements have been implemented, these seem to be piecemeal efforts to date. Each is important. But there needs to be a comprehensive and powerful effort to implement full strength measures across all ministries that would lead to rapid improvement in Egypt's competitiveness. As one international press commentator recently put it, "Egypt is moving in the right direction, but it is moving at about 15 km. per hour while other countries are now moving at 60 or 100 km. per hour."

3. Is Egypt's ranking, halfway down the list of countries, a fair indication of its competitiveness among countries of the world?

Egypt does not seem to be unduly penalized in the Global Competitiveness Report. Declining rankings are supported by hard data. If anything, it performs relatively well in the GCR relative to other indexes that rank Egypt's international performance. The current rankings seem to be a fair portrayal of the current situation. Egypt does much worse on the Doing Business rankings.

The Global Competitiveness Report relies on both hard data and a survey of executives who are in the general management position of either very large companies or companies involved in international trade. The GCR is a reflection of the competitiveness of Egypt's companies that do business globally or that are affected by global trends. It is assumed that these executives can speak with some knowledge about Egypt's relative performance in many competitiveness-related areas. The Doing Business indicators focus on business regulations and obstacles and these tend to have a more negative effect on small- and medium-sized businesses and on businesses in the informal economy. The environment for domestic, small and informal businesses is therefore better measured by this latter set of indicators. One implication of this is that it should be a national priority to decrease the regulatory burden on these companies. The very low ranking of Egypt indicates the desperate situation and urgent priority of bringing a "guillotine" approach to reducing the burdens on Egypt's companies so that they too can compete with the large and/or international companies. This will also help foster an economic democracy where the small businessman, business woman and entrepreneur will see a direct benefit. Improvements here will also help Egypt's ranking on the GCR.

One can conclude from this that large firms and international firms which respond to the GCI Executive Opinion Survey are able to deal with the business environment which is slightly below the average in global standards. However, Egyptian businesses and small- and medium-sized enterprises face a crippling series of barriers and limitations. This will be the subject of Chapter 3 while the "guillotine" approach to resolving this problem will be the subject of Chapter 4.

4. Is enough being done to improve Egypt's competitiveness?

Improvements in Egypt's competitiveness have to date been piecemeal and uncoordinated. There is an urgent need to broaden reforms, deepen reforms, accelerate reforms and bring them together in a comprehensive vision and strategy. There is an urgent need for a comprehensive set of initiatives to implement a national strategy designed to increase Egypt's percentage of world GDP and world exports.

5. Finally, what practical recommendations can be given to Government policy makers and to others that wish to help Egypt improve its competitiveness?

Several key recommendations flow from the above observations. First, it is important to focus on reducing the budget deficit and government debt and bringing inflation under control while doing so in a manner that is conducive to social stability and that protects the poorest income groups. Second, it is urgent to go beyond piecemeal reforms and put together a comprehensive and accelerated set of reforms in which all ministries participate and which is coordinated by leadership at the very top level. Third, it is now urgent to bring a "guillotine" down on the unnecessary rules, procedures and regulations that hamper Egypt's workers, entrepreneurs and small businesses. Doing so will contribute to sustainable growth in a bottom-up way and foster the economic dynamism that is so critical to Egypt's future. Fourth, given the improving but still low indicators related to human resources, private and public sector leaders must focus on improving the skills of the workforce and transforming this workforce in ways that will allow the average person to be more productive, earn more and have the aptitudes and attitudes necessary to help Egypt become more competitive. This requires concerted effort by both the Government and by Egypt's companies. Finally, there is a need to have objective monitoring and evaluation on an annual basis of Egypt's competitiveness performance. This must lead directly to an ongoing and institutionalized private-public dialogue in which the Government is open to and actively solicits the counsel and cooperation of the private sector in designing and implementing an ambitious set of competitiveness-building initiatives. This dialogue should produce, within the next 12 months, a comprehensive competitiveness strategy for Egypt designed to boost its rankings and to boost the underlying competitiveness and economic trajectory of the country.

2.

The Egyptian Economy Three Years Later: Is it Underperforming?

Author: Amina Ghanem

The following chapter reviews the strong performance of the Egyptian economy, analyzes the underlying causes of this performance, discusses the macroeconomic challenges now being faced and presents the current plan of the Ministry of Finance to institute reforms addressing some of these challenges. These macroeconomic reforms, while absolutely essential to Egypt's future competitiveness, will need to be supplemented by many other initiatives to achieve structural change. This will require major changes that improve the business environment and institutional changes in education, research and the civil service. This year, the ECR calls attention to the lack of an overall Egyptian national competitiveness strategy that connects the many piecemeal reforms. While the high growth in Egypt's GDP is commendable, urgent attention is needed to address poverty and to create the conditions for long-term, sustainable growth that will result in tangible improvements for the average Egyptian.

With macroeconomic conditions being addressed in the plan presented below, the remaining agenda of structural reforms will need to be addressed in a comprehensive fashion over the medium term. This chapter makes the argument that there might be no quantum improvement in Egypt's competitiveness rankings in the near future without a major and urgent focus on implementing a national competitiveness strategy that is also pro-poor. The Government can encourage pro-poor economic growth by focusing on economic growth that creates jobs and by continuing to focus on social spending, perhaps in more targeted and efficient ways. The review of some literature shows that a more equitable income distribution could actually help accelerate growth and competitiveness, and generate more resources for further pro-poor policies in a virtuous circle.

2.1 THE EGYPTIAN ECONOMY: STRONG PERFORMANCE IN 2006 AND 2007

In 1990 Egypt was one of the first countries in the region to start an ambitious economic reform program that transformed the economy from closed to market-oriented. Between 1997 and 2004 Egypt faced a number of challenges such as the South East Asian crisis, incidents of terrorism and regional conflict. These factors coupled with policy slippages caused many of the gains achieved during the early reform years to be lost, and Egypt quickly became a severely underperforming economy compared to other international and regional economies. Major economic indicators deteriorated and gains from the reforms of the early 1990s were eroded. The economy was infamous for its unfriendly business environment, volatility, high budget deficit and unstable exchange rate. By 2004, Egypt, once a regional pioneer of change, was behind other developing countries in reforms, attraction of FDI, openness and credibility of economic policy. Egypt's dire economic performance, particularly vis-à-vis other countries in the region, forced a change in most of the Cabinet and all of the economic team in July 2004.

Since 2004, the new has Cabinet successfully implemented profound policy changes.[1] As a result, Egypt is moving towards more openness and flexibility. Perhaps the most important achievement has been restoring macroeconomic confidence.

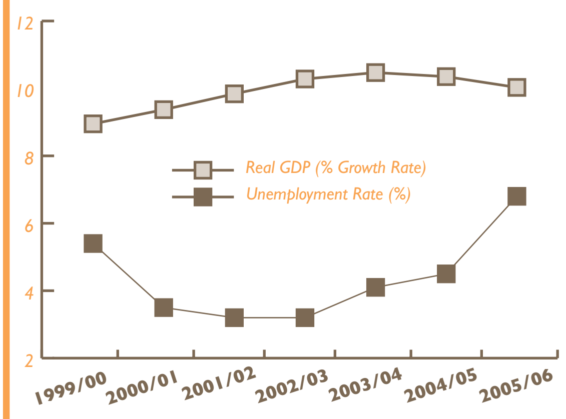
In response to the many reforms implemented by the Government's economic team over the last two years, Egypt's GDP grew at 6.9 percent in 2006 (see Figure 2.1), one of the strongest performances in recent history. This compares to 4.5 percent during the previous year. Steady expansion for some eight quarters since July 2004 has pushed GDP growth rates to 6.9 percent during the first half of fiscal year 2006–2007 (July–December 2006), compared to 6.5 percent during the same period the year before (Ministry of Finance March 2007), ahead of any country in the region.[2] Official unemployment fell to 10 percent (again, Figure 2.1; also Figure 2.2). In nominal terms, exports grew by 160 percent from US$ 7 billion in 2001/2002 to US$ 18.4 billion in 2005/2006 (Figure 2.3). As a percent of GDP, exports more than doubled from 7.6 percent to 17.3 percent. Although there was a significant merchandise trade deficit, Egypt had an overall current account surplus of US$ 1.75 billion. Overall investment was 18.7 percent of GDP and foreign direct investment grew to US$ 7.2 billion or 6 percent of GDP, an exceptionally high figure by both historical and international standards (Figure 2.4). The percentage of population below the national poverty line fell from 22.9 percent in 1996 to 16.7 percent in 2000.[3] These are among the best economic results in Egypt's recent history.

Foreign trade was the driving force in the economic resurgence between 2002/2003 and 2003/2004. Soaring demand for Egypt's non-oil exports boosted economic growth by stimulating an expansion of domestic demand (Figure 2.5). Export profits were used to fuel investment. Rising disposable incomes coupled with the rising credibility of government policies led to increased domestic demand, reinforcing the growth process since 2004/2005. Export demand remains strong.

These macroeconomic results have encouraged private-sector led growth and increased consumer demand (Figure 2.6). Investment also contributed strongly to overall domestic demand (Ministry of Finance March 2007), boding well for the sustainability of economic growth (Figure 2.7). Economically speaking, there has been a virtuous cycle of investment leading to economic growth and stimulating further investment.

Egypt's economy, being more diversified than almost any other Arab country, has significant scope for further growth (Beltone 2006). The overall GDP includes many elements, principally manufacturing/industry at 17 percent of GDP, petroleum at 15 percent and agriculture at 14 percent. These are supplemented by construction at 4 percent, tourism at 3 percent, and government services at 10 percent (Ministry of Finance March 2007).

FIGURE 2.1: *REAL GDP AND UNEMPLOYMENT GROWTH RATES 1999/2000 – 2005/2006*



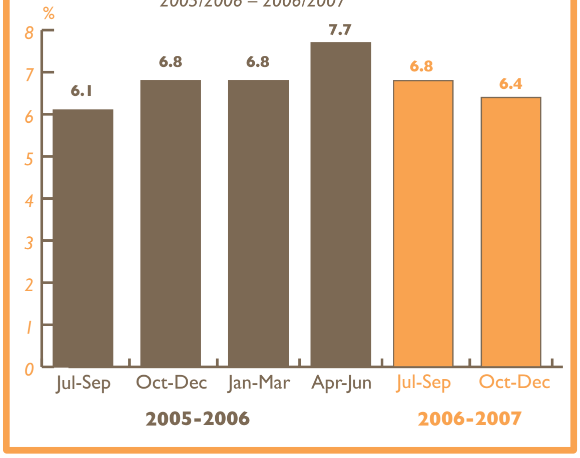
Source: Ministry of Finance (MOF).

[1] Please see the *Egyptian Competitiveness Report 2005–2006*.

[2] Morocco's real GDP growth is expected to drop to 4 percent in 2007, from 8.1 percent in 2006 (Oxford Business Group, April 2007).

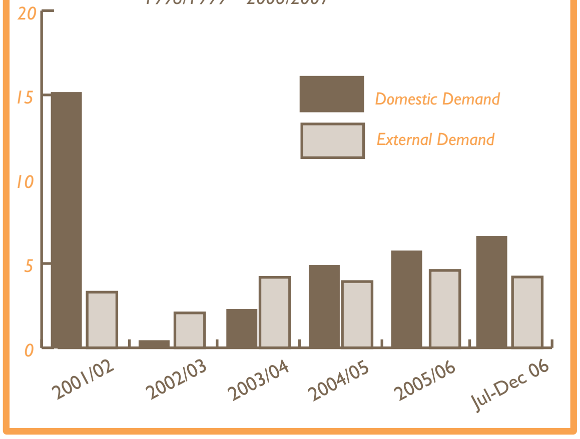
[3] Millennium Development Goals Indicators. http://unstats.un.org/unsd/mdg/Search.aspx?q=poverty%20egypt.

FIGURE 2.2: QUARTERLY GDP GROWTH RATE 2005/2006 – 2006/2007



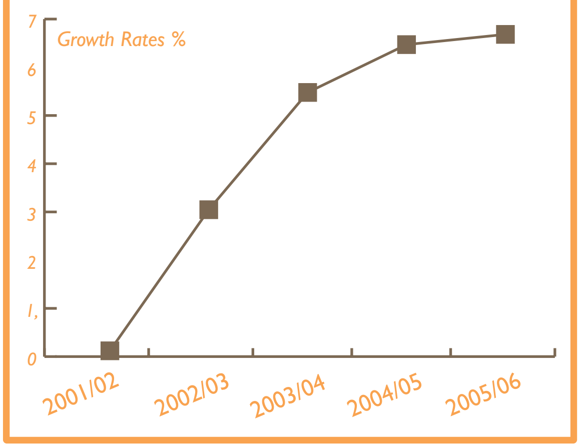
Source: MOF.

FIGURE 2.5: ANNUAL PERCENT CONTRIBUTION OF DOMESTIC & EXTERNAL DEMAND TO GROWTH IN GDP (TOTAL USES) 1998/1999 – 2006/2007



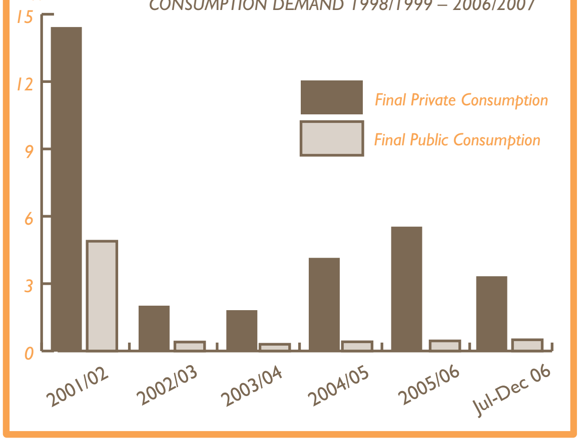
Source: MOF.

FIGURE 2.3: ANNUAL EXPORT PROCEEDS 2001/2002 – 2005/2006



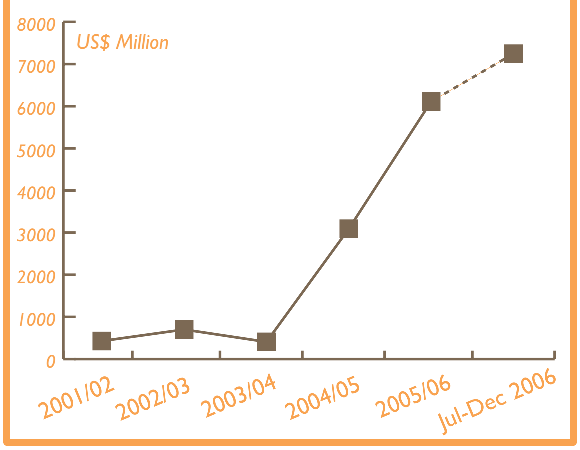
Source: MOF.

FIGURE 2.6: ANNUAL PERCENT CONTRIBUTION OF PUBLIC & PRIVATE CONSUMPTION DEMAND TO TOTAL CONSUMPTION DEMAND 1998/1999 – 2006/2007



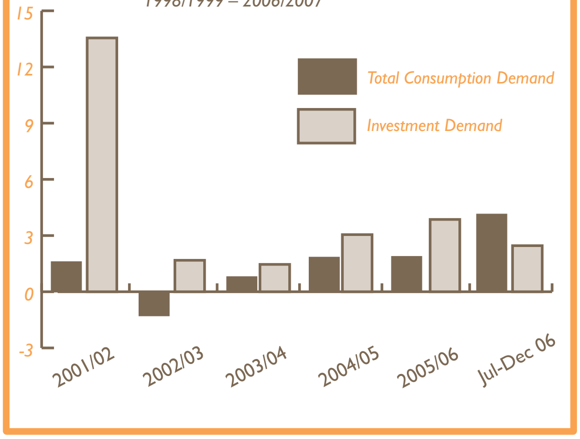
Source: MOF.

FIGURE 2.4: ANNUAL FDI 2001/2002 – 2005/2006



Source: MOF.

FIGURE 2.7: ANNUAL PERCENT CONTRIBUTION OF INVESTMENT & FINAL CONSUMPTION TO GROWTH IN GDP (TOTAL USES) 1998/1999 – 2006/2007



Source: MOF.

Most of the GDP growth is driven by the private sector. Growth from private sector activities contributed 4.9 percentage points of the 6.8 percent growth rate during the first half of 2006/2007. Manufacturing, wholesale and retail trade, construction, and transportation led the private sector's contribution to growth. This is partly due to the country's broadening economic base and improving business environment for the private sector. Cheap gas due to recent discoveries is giving Egyptian companies an edge over competitors. Low cost labor and easy access to the EU and US markets have also contributed to the recent manufacturing growth. Egypt's exports to both markets have grown over the past year by 27 percent and 25 percent respectively. The depreciation of the Egyptian pound against the euro by 11 percent allowed Egyptian exporters to benefit from the rise in domestic demand in countries using that currency. The textile sector remains one of the driving forces of the export-oriented industry and has the additional advantage of being relatively labor-intensive. The QIZ agreement signed in December 2004 with the United States gives Egyptian textiles manufacturers tariff-free access to the US market.[4]

Egypt also has a robust pharmaceutical sector, and food processing has always been a driver of the manufacturing sector. More recently Egypt has changed from being a net importer of fertilizer products to a net exporter. The fertilizer industry employs 34 percent of the manufacturing labor force.[5]

More is being done to promote manufacturing. Special economic zones are another vehicle to provide competitive advantage to manufacturing firms and these have already served to increase manufacturing in fertilizers, iron and steel, pharmaceuticals, building materials and petrochemicals, which all depend on gas for energy. Currently there are two special zones: North West Suez and East Port Said.

2.2 THE EXTERNAL POSITION OF EGYPT IS EXCEPTIONALLY STRONG

The external position remains strong with a current account surplus of US$ 1.8 billion in June 2006 following a surplus of US$ 2.9 billion in 2005. During the first half of 2006/2007, the current account registered a surplus of almost US$ 2 billion. The overall balance is also in surplus, standing at US$ 3.3 billion in June 2006 and registering close to US$ 3 billion in the first half 2006/2007 alone compared to a surplus of US$ 2.5 billion during the corresponding period in 2004/2005 (Ministry of Finance March 2007).

The strength of the external position comes in part from the diversification of the sources of revenues from merchandise exports, services, worker remittances and foreign investment. First, total exports increased by 25 percent during July–December 2006/2007 compared to the previous year, while non-oil exports were diversified and expanded by more than 43 percent. The bulk of the increase in merchandise exports came from exports of furniture, chemicals and fertilizers, garments, electronics, and construction materials. Other exports included books and art materials, upholstery, medications and foodstuffs (Ministry of Foreign Trade and Industry, March 2007).

Second, revenues from the Suez Canal, tourism, and workers' remittances are also helping to keep the current account in surplus. Tourism was not greatly affected by security incidents in 2006, and income from tourism was US$ 7.2 billion in June 2006 compared to US$ 4.3 billion in June 2001. Over the same period, the Suez Canal revenues doubled to US$ 5 billion in response to strong global trade. Growth in tonnage and traffic was visible in non-oil as well as oil-related trade.

Workers' remittances increased sharply from under US$ 3 billion in 2000/2001 to over US$5 billion in 2005/2006 (Ministry of Finance, March 2007). The rise in the number of Egyptians working in the United States and some European countries has increased recently, diversifying if not replacing the flow of remittances from the Gulf (EFG-Hermes, February 2007).

Third, foreign direct investment at US$ 6.1 billion during 2005/2006 was 15-fold its level in 2003/2004. Some 45 percent of the FDI is related to Greenfield investment in real estate and new establishments, while oil and gas sector investment and privatization take up the rest. This compares favorably with the composition of FDI in 2004/2005, where oil and gas investments made up 54.8 percent of total FDI flows (Ministry of Finance March 2007). Foreign direct investment is expected to continue to grow strongly over the medium term, underpinned by restored confidence, appreciation expectations and competitively priced assets (EFG-Hermes February 28, 2007).

[4] Ministry of Finance (December 2006).

[5] Ministry of Finance (March 2007).

As a result of these combined results, net international reserves have surpassed all past records, reaching more than US$ 27 billion in March 2007. External debt is safe by international standards. Foreign debt as a percent of GDP has steadily declined, falling from more than 42 percent in June 2003 to 25 percent in December 2006 (Ministry of Finance, March 2007).

The Balance of Payments performance, being both strong and diversified, will serve as a buffer against exogenous shocks to any one source of revenue.

2.3 DESPITE GOOD OVERALL RESULTS, INFLATION, BUDGET DEFICITS AND OTHER SIGNIFICANT MACROECONOMIC CHALLENGES REMAIN TO BE ADDRESSED

Despite these very positive results, inflation remained high at 12.4 percent and the budget deficit was among the world's highest at around 9.3 percent of GDP in 2006. Gross domestic budget sector debt fell from 101 percent of GDP in 2004/2005 to less than 90 percent in June 2006. This figure continues to fall and reached 76 percent of GDP last December. These results have not yet been taken into account in Egypt's recent competitiveness rankings. Net domestic budget sector debt fell from 71.7 percent to 61 percent over the same period (Ministry of Finance, March 2007). Underemployment remains significant and there is some worry that the economic growth may still not be generating the employment necessary to accommodate high growth in the labor force while also drying up the pool of the existing unemployed and underemployed.

Egypt's budget deficit has been stubbornly high at about 9 percent of GDP since the beginning of the millennium. It is projected to go down to 5.5 percent in June 2007 due to unexpected windfall gains that flowed to the budget during 2006/2007. Without these one-off proceeds the deficit would only have gone down to 7.3 percent.

Fiscal consolidation could proceed more rapidly, but urgent pro-poor strategies and social concerns will limit any draconian approaches to trimming Government expenditures. The Government has opted to finance the needed spending essentially through savings from implementing structural reforms that will bring about a substantial rise in revenues and significant permanent savings that will put the budget deficit on a gradual but firm downward trajectory. One-off windfall receipts that the budget saw in 2006/2007 will complement these reforms and enable further social spending to kick off more equitable growth that should stimulate further economic expansion.

The choice to embark on continued social spending and gradual consolidation is not without cost. It could delay imminent improvements in Egypt's macroeconomic competitiveness indicators. At the same time, by addressing the underlying issues in the economy this option could give time for the structural changes to yield permanent improvements in Egypt's competitiveness.

Some of the structural reforms already implemented include tariff cuts, trade reforms, income tax reductions and tax administration reforms. The objective of these reforms was to widen the taxable base while lowering rates, encouraging new entrants into the formal business sector, providing amnesty for arrears, and simplifying compliance by putting the burden of proof on the tax authority. These reforms have increased tax revenues by some 11 percent, while tariff rate cuts increased customs receipts by almost 17 percent. Other tax cuts in the pipeline include the reduction of property tax rates from over 40 percent to 10 percent in the near future.

The Ministry of Finance is also implementing a number of structural reforms to the budget that will create permanent savings. The 40 percent reduction in energy subsidies in July 2006 has created savings of LE 6 billion on an annual basis. Interest payment savings from implementing the Treasury Single Account and automation of government payments and receipts will save the Government more than LE 2.7 billion annually effective from FY2006/07. Other large savings will come from eliminating the intermediary role of the National Investment Bank (NIB) with the Social Insurance Funds (SIF). Established in 1980, the NIB financed the government's investment plan by lending the SIF and postal authority deposits to the Ministry of Finance, economic authorities and other entities. The debt incurred by the Ministry of Finance through this operation reached LE 197.7 billion in June 2006, and included re-capitalized interest. The Minister of Finance issued an interest-bearing bond for this debt and suspended borrowing through the NIB.

Furthermore, the implementation of a new pension system will reduce the need for financing from the Treasury as new entrants join the fully funded defined contribution system. Under the new system, the Ministry of Finance will borrow the needed cash and deposit the interest into notional accounts[6] directly. Estimates of savings from adopting this new system once the new legislation is passed in 2008 are in the range of 3–4 percent of GDP. Furthermore, the new system will boost investment in debt instruments, further deepening the domestic debt market and contributing to fiscal consolidation by reducing the transaction costs of domestically traded debt.

The adoption of public-private partnerships in education and water sectors will open the door towards adopting this partnership model for other public investments, and will enable the government to increase social and capital investments by some 26 percent without overly burdening the budget.

As a result, fiscal revenues are increasing at a faster pace than expenditures, and the budget deficit is projected to fall from 9.1 percent of GDP in 2006 to 7.3 percent in June 2007 (see Table 2.1).

Unexpected budgetary revenues from the sale of the third mobile license (LE 15.2 billion), Egypt Telecom revaluation (LE 3.1 billion) and large privatizations, mainly Bank of Alexandria and Omar Effendi (LE 9.8 billion) had not been factored in the projections, and thus reduce the June 2007 budget deficit to 5.5 percent. The Ministry of Finance projects that in 2008, the deficit will go up again to 6.7 percent after the impact of the windfall proceeds dissipates, but it will be within the range announced by the Ministry of Finance to reduce the budget deficit by an average of one percentage point on an annual basis over the medium term.

Table 2.1: The Budget Cash Deficit — With and Without Windfall Receipts: 2002/2003–2007/2008

LE Millions	2002/03	2003/04	2004/05	2005/06	2006/07		2007/08 Proposed Budget	
	Actual				Budgeted	Expected after windfalls		
Revenues Growth Rate (%)	13.8	14.3	8.8	36.4	8.4	13.8	7.3 over expected	12.8 over budgeted
Expenditures Growth Rate (%)	10.2	14.7	10.7	28.6	4.6	2.1	13.9 over expected	11.5 over budgeted
Cash Deficit (% GDP)	9.1	9.1	9.4	9.1	7.3	5.5	6.7	

Source: Ministry of Finance.

2.4 SOCIAL SPENDING WILL TAKE PRECEDENCE OVER BUDGET DEFICITS WHICH WILL BE REDUCED GRADUALLY

The Minister of Finance announced on a number of recent occasions[7] that the policy choice made by the Ministry in dealing with these windfalls was to put the budget deficit on a gradual but more sustainable downward trajectory over the next five years. The view is to address social development comprehensively, rather than use the proceeds to effect drastic immediate reductions in the deficit. Social spending will in the long term support stronger growth.

Such a path of adjustment is in line with other international practices. While some countries such as Nepal and Vietnam have contained public expenditure — despite managing large revenues — in order to achieve significant lowering of the fiscal deficit, Bangladesh and Philippines have opted to use part of their revenue gains to bring down their fiscal deficit and the remaining part to raise the level of public expenditure. In countries such as Malaysia, Pakistan, Indonesia and Sri Lanka where fiscal revenues were weak, major cutbacks in public expenditure had to be made in order to contain the budget deficit. In Pakistan and Sri Lanka, capital expenditure as a percentage of the GDP fell by almost 50 percent. In these two cases the contractionary fiscal policy was found to exert a strong negative influence on the process of growth (Pasha and Palanivel 2004).

[6] A notional account is a hypothetical account created for each insured person. It contains all contributions made during the employee's working life and is maintained by the government on behalf of the pensioner.

[7] Speeches by the Egyptian Minister of Finance Youssef Boutros-Ghali in Washington at the CATO Institute, JP Morgan's Investors Conference and the Business Council for International Understanding (BCIU) during April 2007.

Based on the findings of their paper, Pasha and Palanivel (2004) propose that governments should adopt growth-oriented versus contractionary stabilization policies. Higher levels of public investment on pro-poor policies can be made as long as they are supported by appropriate monetary and exchange rate policies. The impact of public spending on poverty reduction and the linkage to growth is discussed in some detail later in this chapter.

From this perspective, restoring fiscal discipline in Egypt over the medium term will be achieved by fixing the underlying structural imbalances in the budget which temporary revenue elements alone will not resolve. The windfalls will provide the resources to address equity in income distribution without risking contraction in the name of fiscal austerity.

Addressing equity is a key component in growth policies. According to the OECD (2004), while growth is necessary for the incomes of the poor to rise, the distribution component is essential so that governments ensure that the poor are not disadvantaged in the process and that inequality does not lower the subsequent rate of growth. If growth encompasses the whole country and economy, it is likely to be faster and provide greater opportunities for the poor. A pro-poor competitiveness strategy should ensure adequate focus on rapid economic growth in those regions where the poor live and in those sectors from which they earn a living.

Thus in the case of Egypt, the windfall gains will be in large part spent on rehabilitating the long neglected railway sector, sewage, investments in upper Egypt, development grants for industry, retraining of labor, health insurance reform, training of the workforce and enhancing the quality of teachers. These are all measures designed to tackle urgent equity and development issues that the market mechanism and economic growth do not address in the short term. A total of LE 22 billion will thus be spent between 2006/2007 and 2007/2008 to address equity and development issues.

The development grant for Upper Egypt, which has historically been marginalized compared to the Delta, will pay particular attention to income distribution issues and development plans. The grant for retraining of labor will empower labor with skills needed by the market, which the current education and vocational training system is not providing.[8]

Table 2.2: Pro-Poor Spending to Address Income Redistribution: 2002/2003–2007/2008

	2006/2007	2007/2008
	LE Billions	
Railways	3.0	2.0
Sewage	2.0	
Restructuring the public sector and retirement of non-performing loans	9.2	
Development grant for Upper Egypt	0.8	0.2
Development grant for industry		0.6
Retraining of labor		0.5
Upgrading teachers' salaries		1.6
Healthcare		0.4
Housing subsidy (concessional loans, subsidizing cost of units)		1.7

Source: Ministry of Finance.

On healthcare, the Ministry of Health is developing a project to finance the establishment of a National Health Insurance Fund, which will be the main vehicle for achieving a universal health insurance system. The project aims to support the initial expansion of health insurance coverage to the uninsured, with emphasis on the enrollment of the poor in selected governorates (World Bank 2007).

The Ministry of Health will develop a strategy for fiscal sustainability combining contributions from household premiums, acceptable levels of out-of-pocket payments and tax-based budget support for priority groups. Preliminary projections indicate that it would cost about LE 3–5 billion per year to cover the poor, and an equal amount to cover the uninsured non-poor population. A saving that will be made through this project is the termination of treatment at the expense of the state, which is costly, highly inequitable and has limited coverage.

[8] The Ministry of Education Strategy Paper describes how the whole system will be revamped in the medium term.

In addition to direct spending from the budget to tackle development and equity issues, a new and important element of change has been to outsource spending to the private sector through a Public Private Partnerships (PPP) approach. This approach draws on the strengths of the public sector in regulation and supervision and the strengths of the private sector in financing and delivering services previously performed by the public sector. Expanding the private sector role allows the public agencies to tap private sector technical, management and financial resources in new ways to achieve certain objectives such as greater project cost savings, efficiency gains through expedited completion by a more efficient implementer, innovative technology applications, and access to new sources of capital through the private sector. PPPs create an incentive to ease budgetary constraints in the short term without worrying about longer term sustainability. Private financing supports increased infrastructure investment without adding to government borrowing. Private financing reduces the strain on the government budget not only in terms of initial capital outlays but also in terms of recurring current expenses related to operations and maintenance.

The Ministry of Finance plans to inaugurate PPP projects in the social sector, starting with schools and water treatment and sewage plants. These projects will enable the government to increase investments in 2007/2008 by 26 percent over the previous year. Some PPP projects worth LE 5 billion are in the investment plan for 2007/2008.

Another PPP project still in the early stages of formulation is one that would connect natural gas to 6 million households over the next two years to replace usage of Liquefied Petroleum Gas (LPG) by consumers.

LPG is used by all income groups in Egypt for cooking. In the case of higher-income households it is also used for water heating. Commercial and industrial consumers use LPG for a number of different applications, including heating, cooking, and operation of boilers. Egypt consumes more than 3 million tons of LPG per year, of which over half has to be imported.

A gas distribution network is starting to emerge in urban and semi-urban areas in the Nile Delta concentrated in and around the cities of Cairo, Suez and Alexandria, currently serving around 2 million industrial, commercial and residential customers. However, the vast majority of residential households in the Nile Delta continue to use LPG to meet their domestic energy needs. LPG subsidies cost the Government more than US$ 1.5 billion, equivalent to 1.5 percent of Egypt's GDP (World Bank 2005).

Besides the macro and micro benefits expected, increased consumption of natural gas relative to LPG also creates important social, environmental and health benefits. Natural gas is also used as fuel for the domestic market, since about 80 percent of Egypt's electricity production relies on natural gas. There is also a large and growing demand for natural gas by industrial, commercial and household customers. Increasing the domestic use of natural gas is thus a key priority for Egypt, given that it would replace consumption of heavily subsidized LPG (World Bank 2006).

The total cost of the petroleum subsidy is LE 40 billion, or 76.5 percent of the total subsidy bill of LE 52.3 billion. The LPG subsidy costs LE 8.6 billion or almost a quarter of petroleum subsidies. The investment in new connections that will switch households' future consumption of LPG to natural gas will save the Ministry of Finance the cost of the LPG subsidy, approximately LE 600 annually per household. The cost of getting connected to the network for a consumer is about LE 2,500, two-thirds of which will be paid from the budget (World Bank 2006). Thus the cost of the investment will be financed by only three more years of subsidy, while the future savings from the LPG subsidy can be redirected towards social spending that targets marginalized groups.

Thus although the Government recognizes the importance of fiscal consolidation, it has taken the decision to achieve it more gradually. The rationale is that strong growth rates alone cannot increase welfare or address income redistribution. Pro-poor policies and interventions that are consumer-oriented and fiscally sustainable must be followed in the medium term.

In the meantime, there is no immediate threat from public debt levels. The consolidation of public debt by netting out cross-indebtedness between the National Investment Bank and the social insurance funds has resulted in the partial reduction of gross domestic public debt from 88 percent of GDP in June 2005 to 65 percent in December 2006. Over the same period net domestic debt fell from 52 percent of GDP to 42 percent. Other sources resulted from healthy GDP growth and privatization proceeds (Ministry of Finance, March 2007).

In addition, public debt management has significantly improved. First, the maturity of tradable public debt has gone up from 165 days in 2003 to two years in 2007, thus reducing refinancing risk. Second, private sector holdings of treasury bills, including foreign investors, have gone up. Third, purchase and re-purchase agreements have been introduced while bond lending and short selling have become active features of the secondary market. An international issuance of long term debt denominated in Egyptian pounds (LE 5 billion) that will be made in the summer will serve to lengthen the yield curve and give the secondary market the liquidity it needs to make debt trading more efficient and less costly. [9]

2.5 COMPREHENSIVE MACROECONOMIC, STRUCTURAL AND INSTITUTIONAL REFORMS ARE URGENTLY NEEDED IN THE CONTEXT OF A NATIONAL COMPETITIVENESS STRATEGY

Despite high economic growth rates, Egypt witnessed a significant worsening in its competitiveness ranking due mainly to deterioration in its macroeconomic competitiveness and the lack of rapid improvement in other areas. Does the slippage constitute a trend? What can be done to further increase Egypt's competitiveness? How can a national competitiveness strategy also further support pro-poor economic growth? Can social spending and social investment improve the productivity and incomes of the poor?

To answer these questions, this chapter uses the framework of the "drivers" of competitiveness used by the United Nations Industrial Development Organization (UNIDO). UNIDO has found that drivers of competitiveness include macroeconomic conditions, macroeconomic policies and support institutions (UNIDO 2000). This chapter focuses on the first two of these drivers:

- **Macroeconomic conditions** include aggregate demand, fiscal deficit, inflation, interest rates, exchange rates and unemployment.
- **Macroeconomic policies** include industrial, monetary, foreign exchange, fiscal, trade and investment policies.

Using this framework, this section makes the argument that Egypt's competitiveness has deteriorated because of the lack of a comprehensive national competitiveness and reform strategy, which has led to mixed performance and weak translation of economic reforms into real impact.

2.5.1 Macroeconomic Conditions

Despite more than two years of unprecedented and robust growth, four major problems remain unresolved: the budget deficit, inflation, unemployment/productivity and barriers to formalization and growth of small and medium businesses

2.5.1.1 Budget Deficit

Gradual fiscal consolidation could prove challenging to monetary policy and inflation rates. The longer fiscal consolidation takes, the greater the risk for high inflation and a contractionary monetary policy. Wages and subsidies will prove difficult to address. There is also a need for higher investments to replace existing infrastructure and address the social safety net. Health insurance reforms pose further tests to fiscal reforms.

Subsidies in particular represent an important challenge. Great strides have been made as described earlier in this chapter to reduce energy subsidies. However, the weighted average of petroleum products is about 60 percent of their international price. By continuing to subsidize products, not poor households, the government is creating a number of problems including an unsustainable budget deficit and inefficient and wasteful use of limited resources.[10]

This subsidy provides indirect support of capital-intensive manufacturing industries, not labor-intensive industries. Reallocating subsidies from capital-intensive producers to low income consumers will help the poor in two ways. They will receive direct support and more jobs will be created in labor-intensive sectors.

[9] Announcement made by the Egyptian Minister of Finance Youssef Boutros-Ghali in Washington at the CATO Institute, JP Morgan's Investors Conference and the Business Council for International Understanding (BCIU) during April 2007.

[10] According to Egypt's Human Development Report (UNDP 2005), energy is a major source of income that generates a large share of foreign currency. Egypt's energy intensity, defined as total primary energy consumption per unit of GDP, has increased by 1.5 percent per year since 2001. The energy intensity for Egypt is much higher than for peer countries such as Algeria, Morocco and Tunisia. Compared with OECD countries and Europe, Egypt uses twice as much energy per unit of GDP.

Domestic debt seems to be under control however, and will most likely support fiscal consolidation efforts. Rising social and capital expenditures could compromise the domestic debt position and prudent debt management unless the government speeds up its fiscal consolidation.

2.5.1.2 Inflation

Inflation is still high at 12.4 percent, following a period where inflation averaged less than 4 percent. A number of cyclical factors fueled the rise in inflation. Food price growth accelerated in December 2006 because of agricultural produce supply constraints. Another outbreak of avian influenza pushed up prices of meat and other non-fowl protein, compounded by a nearly simultaneous cattle disease. There was also the administrative rise in prices of utility services such as water as well as energy prices in the second half of 2006. Inflation was further boosted by strengthening domestic demand, fueled by large cuts in income tax rates and a reduction in government subsidies for energy products. Despite the persistence of inflation since last year, the Central Bank has been hesitant about raising interest rates. It raised them by a total of 75 basis points, and pursued aggressive sterilization through treasury bills. This was not sufficient to absorb monetary liquidity. Monetary policy has been insufficient to address inflationary pressures and will be further challenged by gradual fiscal consolidation. If inflation does not start receding soon it could run the risk of becoming entrenched.

However, there are indicators that inflation is retreating. The month-on-month increase has inched down from 0.6 percent in January 2007 to 0.3 percent in February. According to the Governor of the Central Bank in an interview in Al-Ahram newspaper recently, inflation should subside to single digit rates in the summer. The Minister of Finance also announced that he expects prices to stabilize when the fuel price increases and second-round effects work their way through the economy. Price growth should be constrained by the stability of the Egyptian pound against the US dollar (and other major currencies). The improvement of the monetary framework and the movement towards inflation targeting, announced but never implemented, should help bring the average rate of inflation down to around 6–7 percent in 2008, according to the Ministry of Finance.

2.5.1.3 Unemployment/Productivity

Reducing unemployment (officially standing at about 10 percent) will require various initiatives. The mismatch between the education system and the needs of the domestic market has resulted in unemployable labor that does not possess the skills required by the market. The education system does not encourage innovation and creativity, and hence labor productivity and value added are among the lowest in the region.[11] This is due to a number of causes:

1. As a consequence of slow growth and high unemployment in the past years, there has been enormous pressure put on informal sector activities. This has translated into falling labor productivity and income levels in the services sector.

2. Access to the education system is not equitable. The testing system has enabled private tutorship that feeds on the system of one-time testing, not cumulative assessment. It has the socially regressive impact of diverting teachers away from focusing their energy with all students in the classroom toward focusing it on those with the means to pay for extra tutoring. In addition, vocational training programs have come to be viewed as a second class alternative rather than as a valuable way to acquire practical and marketable skills. Moreover, there are problems with the content of curricula (Ministry of Education 2007). Thus, education, poverty and unemployment are all interlinked and put the government's commitment to reform to the test.

3. Workers need appropriate protection but the labor market must be modernized. Targeted assistance to the unemployed, including unemployment insurance, placement and retraining services, can help provide for economic security. However, it is also necessary to make it easier to both hire and fire people if businesses are to be encouraged to create more jobs. Social protection systems need to cover workers in both formal full-time employment as well as other employment situations. Providing all workers with a minimum level of social security would also relieve the government of the burden of hiring workers just to provide this security.

[11] Other aspects of low labor productivity were discussed in last year's *Egyptian Competitiveness Report.*

Macroeconomic policies on education and training
To reduce unemployment and enhance productivity to the greatest possible degree, the Government must abandon policies that worsen existing problems, focusing instead on ways to improve education, training, financial sector intermediation and ICT. Policies establishing industry specific infrastructure, education, and training must be developed more aggressively.

Innovation needs to be led by the private sector but supported by Egypt's scientific research institutes, which are government bodies. Universities and national academies require a major overhaul to become engines of innovation. They need greater interaction with the private sector. It is important to increase spending on science, technology and education, which are main pillars of sustainable competitiveness. Egypt's performance on the innovation policy index is weak, which implies that policies to promote the adoption of innovation are deficient.

Productivity growth has been disappointing. Historically labor productivity has been low in Egypt. On average Egyptian workers turn out less per hour than their counterparts in Jordan.[12] Egypt's peers in the region and elsewhere are moving up the value added ladder in manufacturing at a much faster pace. Secondary schooling and vocational training in Egypt need to do more to support Egypt's transition to value added production and a knowledge economy. The first challenge is to put in place the education infrastructure that will provide Egypt's labor force with the skills that will enable it to increase productivity and value added.

2.5.1.4 Access of Small Businesses to Finance

Credit growth to the private sector has been slow, reaching a low of 3.6 percent of GDP by the end of 2004, but has more recently picked up to 10.3 percent (Ministry of Finance, February 2007). Inefficient credit and risk policies coupled with unskilled human resources in the public banking sector have led to reluctance on the banks' side to extend new loans after the non-performing loans crisis in the early years of the millennium that saw non-performing loans of 25 percent.

The recent moderate improvement in private sector credit growth rates will be enhanced by the entry of foreign banks and ongoing privatizations. According to Pasha, this would encourage the provision of micro credit to low income households and to small and medium enterprises. The emphasis should be on increasing access rather than on subsidized credit. The experience of financial institutions like Grameen Bank of Bangladesh is that intermediation costs could be kept low through group-based lending while the repayment performance could be sustained at high levels, even at near market rates of interest, through peer group pressures and the prospect of repeat borrowing.

In Egypt, there were an estimated 3.3 million SMEs in 1998 employing 7.3 million workers, up from 2.9 million units in 1988 employing 5.7 million workers. SME employment accounted for 38 percent of total employment in 1998 (UNDP 2005).

Policy makers have generally had an ambivalent attitude towards the informal sector. On the one hand, informal firms tend to evade taxes and sometimes engage in illicit activities. On the other hand, the sector acts as a cushion for the poor in providing some minimum livelihood. The regulatory framework needs to reduce impediments to formalization and foster access to credit if SMEs are to generate employment. (Chapter 3 discusses these issues in greater detail.) Management and technical extension services may also help to encourage SME development.

At present, SMEs face complex regulations and transaction costs in establishing and operating their businesses, and thus the majority prefer to operate on an informal basis. This acts as a deterrent to linkages with larger enterprises and government procurement. SMEs depend on their own savings and resources to finance their projects, hence limiting their ability to grow. Commercial Banks, NGOs and the Social Fund for Development supply only 6 percent of SMEs with initial capital. The percentage of SMEs depending on loans to finance working capital expansion was no more than 10 percent in 2003 (UNDP 2005).

With regards to technical services, less than 0.5 percent of small businesses utilized technical services. High schools and universities need to do more to prepare graduates with entrepreneurial skills (UNDP 2005).

[12] See the *Egyptian Competitiveness Report 2005-2006.*

2.5.2 *Macroeconomic Policies*

The Cabinet built on the work of the early 1990s reformist government, while trying to combine free markets with social justice. The government has continued to modernize the financial market by reducing its ownership in state-owned banks. It has also unloaded many state-owned enterprises. Total privatization proceeds since July 2004 amount to more than LE 33 billion.

Tax policy, competition policy, and budget structural reforms, including energy subsidies, can help bring about structural change while reducing inefficiency in public administration, even if it will take time to see the impact.

Cutting red tape will facilitate investment and job creation. Much remains to be done to transform Egypt's economy into a more hospitable business environment that can compete with other regional business centers. The Doing Business indicators point to the urgent need to address this. The trend worldwide is to remove impediments to small business as a means of stimulating entrepreneurship, investment, employment and innovation.

2.6 PIECEMEAL REFORMS NEED TO BE REPLACED BY A COMPREHENSIVE NATIONAL STRATEGY FOR COMPETITIVENESS LED BY A HIGH AUTHORITY

The Egyptian Competitiveness Report 2005–2006 made the argument that Egypt's macroeconomic conditions had improved considerably but that structural reforms were needed to achieve sustained economic growth and competitiveness on a long term basis. These structural reforms are still urgently needed; furthermore, Egypt's ranking on the macroeconomic index worsened this year.

The decision to implement macroeconomic and structural reforms requires political will. Once that will is present, all it takes is a decree or removal of impediments. Examples include unifying multiple exchange rates in the early 1990s and removing the foreign exchange surrender requirements in late 2004. Both decisions allowed market mechanisms to operate freely. The spill-over effects were immediate and impressive: spiraling foreign exchange reserves, strong FDI flows, and a stable Egyptian pound.

In ministries where reform-oriented leadership has taken charge, structural changes were implemented fairly rapidly. Tax reforms, tax rate cuts, slashing of tariff rates, trade reforms, rapid privatization, and regulatory improvements were all tough decisions made by a handful of tough ministers. Important as these transformations are, they represent but a first stage in a series of steps that are still urgently needed. Some of the recent economic gains are from one-off events that will have a temporary impact on competitiveness and will not make a structural transformation that can influence long term growth. Examples of such windfall gains include privatization inflows. However, a number of commendable structural changes are taking place. Structural reforms take time to have an impact because they involve the human element in implementation, as opposed to some macro reforms that require the political will to issue a decree. This accents the importance of development policies and support institutions in addressing education, training and productivity issues, a long-term process that will not yield overnight gains.

Currently, economic reforms in Egypt in are concentrated in sectors led by a handful of reformists. This means that there is no overall national competitiveness strategy. Piecemeal efforts are improving competitiveness only within the limited sectors where reforms are taking place, and are not sending strong enough ripple effects to the rest of the economy. Responding to this market challenge will require the design and implementation of competitiveness policies that move the economy beyond its traditional reliance on macroeconomic or one-off piecemeal reforms. The first step in articulating a strategy to improve competitiveness requires a rigorous appraisal of the overall policy framework for competitive performance of the economy in combination with an assessment of prospects and barriers to improving competitiveness. The second equally important step is to build political impetus to drive the strategy to implementation. Without these two prerequisites there will be no quantum leap impact on competitiveness. Finally, it requires an ongoing monitoring and evaluation capacity to accurately report on progress.

The lack of a critical mass of reforms is squeezing the political space for the reformists, and putting pressures on them to perform more, while the nonreformers are not participating. Drivers such as the support institutions have seen almost no reforms whatsoever. To transform Egypt from a temporary growth phenomenon to a thriving economic powerhouse, Egypt must redesign the piecemeal reform agenda into a comprehensive and systemic strategy with competitiveness as a focal objective.

2.7 TOWARDS A "PRO-POOR ECONOMIC GROWTH STRATEGY"

What can the Government do to enhance the connection between policies geared towards greater growth and their impact on competitiveness? How can the impact of reform policies on competitiveness be expedited so that people feel the effect of these changes?

Since 2004, the Government has intensified the implementation of various structural economic reforms, which have included trade liberalization, financial sector reform, privatization, deregulation and removal of restrictions on foreign private investment. These changes have resulted in faster economic growth, but it is not clear what the consequences have been on reducing income disparities. The percentage of the population in Egypt under the national poverty line is 20.2 percent, compared to 19 percent for Morocco, 11.7 percent for Jordan and 7.6 percent for Tunisia. Egypt hopes to meet the UNDP Millennium Development Goals and reduce this number to 12.1 percent by 2015.

Pro-poor policies not only focus on poverty alleviation but also help to raise the productivity of the poor and empower them to get out of the poverty trap and contribute to the growth of their economy.

During the 1950s and 1960s, the primary objective of developing countries was raising levels of investment in order to achieve rapid growth that would lead to a "trickle-down" effect, largely through higher employment and real wages. The expectation was that this would help reduce poverty. There were no explicit pro-poor policies, but only "pro-growth" policies which it was hoped would to lead to poverty reduction eventually. Nevertheless, many developing countries experienced rising income disparities. Thus it was deemed fit during those two decades to design targeted anti-poverty interventions in the form of "social safety nets" to reach groups that remain marginalized by the process of growth (Pasha).

The experience, however was that the countries most successful in reducing poverty have been those that achieved high levels of economic growth while also taking steps to ensure a focus on poverty reduction. It is now being recognized that policies improving the purchasing power and productivity at the "base of the pyramid" improve equity while being pro-growth.

The lesson from a generation of economic development is that a strategy which focuses primarily on reducing inequality through redistribution of assets or incomes, but ignores growth, is unlikely to lead to a sustained process of poverty reduction. While macroeconomic stability is essential for pro-poor growth, helping to sustain growth and ensuring that the incomes of the poor are not damaged by inflation or economic crises, it needs to be achieved through a flexible approach. Rigid adherence to fiscal and inflation targets that do not take account of the potentially high returns to social investment, may undermine growth unnecessarily (OECD, 2006).

The World Bank's World Development Report 2006 also stresses that greater equity is crucial to sustainable growth and development. According to the OECD (2006) countries like Egypt and Brazil that enjoyed high rates of growth in the 1970s, but did not invest in human capabilities, were unable to sustain growth because the productivity of the workforce failed to increase, thus reducing growth in later years. Equally, without growth, it is unlikely that investing in the capabilities of the poor will be translated into reduced income poverty because the poor will not have the opportunity to use their new capabilities to earn higher incomes, as evidenced by the experience of Jamaica. Countries such as India were able to increase growth with slow improvements in human development. Others, such as China, invested heavily in human development before bringing about rapid, sustained growth. What is clear, however, is that no country can maintain growth unless that growth is accompanied by major gains in human development. Without sustainable growth it will be harder to find resources to focus on poverty reduction in the absence of growth (Pasha).

The OECD (2006) also maintains that sustained growth is essential for reducing economic poverty. Evidence across countries and time periods shows that long-term reduction in income poverty results first and foremost from growth. Studies of the experiences of 14 developing countries during the 1990s found that income poverty fell when there was growth, but the key to reducing economic poverty lies in ensuring that a rapid rate of growth is sustained over the long term. Growth may start for a variety of short-lived reasons: discovery of natural resources, higher commodity prices, or a better investment climate for the private sector. However sustaining growth requires deepening of fiscally sustainable pro-poor policies.

Other studies have attempted to quantify the relationship between economic growth and poverty reduction across countries. (Ravallion & Chen 1997; Bruno, Ravallion & Squire 1998; and Adams 2003). These studies found that when income change was distribution-neutral, a one percentage point increase in the rate of per capita income growth can produce up to a two percent decrease in the proportion of people living below the poverty line.

A pro-poor pattern of growth makes growth more effective in reducing poverty. Developing countries with similar rates of economic growth have experienced quite different levels of poverty reduction, depending on whether they invested in basic social services, social protection and infrastructure (OECD, 2006). Easterly and Rebelo (1993) show that an increased government expenditure on transport and communication of 1 percent of GDP is associated with an increase in annual per capita GDP growth of approximately 0.6 percentage points. Increased government expenditure on health and education contributes to the well-being of a population and increases worker productivity. Reducing communicable disease also increases worker productivity and helps to promote tourism and attract foreign direct investment. According to Bloom, Canning and Jamison (2004), health improvement has a significant impact on GDP growth. An additional year of life expectancy can raise a country's per capita GDP by 4 percent.

Income inequality hinders the ability of poor people to participate in and contribute to growth. High and rising levels of income inequality lower the poverty reduction impact of a given rate of growth and can reduce the political stability and social cohesion needed for sustainable growth (OECD, 2006). Many Asian countries have experienced limited poverty reduction despite impressive growth performance. A one percentage point increase in the growth rate of per capita income has translated into only a 0.9 percent decline in the incidence of poverty in the region. Inequality as a whole worsened during the 1990s, and while it has been successful in achieving high rates of economic growth, gains with regard to poverty reduction have been limited by the absence of pro-poor growth policies (Pasha and Palanivel 2004).

Thus, reducing poverty requires an in-depth search and understanding of the strategies that can directly address income redistribution on a long-term basis. According to Pasha and Palanivel (2004), macroeconomic policies are important determinants of income distribution. A successful economic policy is thus one that operates to increase incomes and jobs through economic growth. The results of a study of cross-country experiences indicate that a successful economic reform strategy focusing on a sustainable rate of economic growth that addresses equity should possess two key characteristics: a high rate of employment generation and rapid agricultural growth. Employment is one of the main channels through which the link between economic growth and income re-distribution is established. As the level of income is the key determinant of income class, and as productive employment is the principal source of income, expanding gainful employment opportunities has to be a major element in the strategy of poverty reduction. Clearly, employment growth depends upon the growth of the economy.

Empirically the rate of employment growth is also influenced by the sectoral composition of economic growth. If economic growth is concentrated in sectors in which most of the marginalized population works, such as agriculture, then this is likely to have a positive implication for equity. In particular, since the bulk of poverty is rural in character, agricultural growth has a crucial role to play in the process of poverty reduction, through both its direct effect within the rural economy and through the spill-over effects on the urban economy. (Ravallion 2001, Datt and Ravallion 2002). Also, for the same rate of economic growth, the impact on income distribution is likely to be more pronounced the faster the rate of agricultural growth (Pasha and Palanivel, 2004).

Strong job growth could help poverty decline by an average rate close to 5.5 percent. Reduction in unemployment with strong agriculture growth can cause poverty to decline by as much as 7 percent annually (Pasha and Palanivel, 2004).

The importance of employment growth in contributing to poverty reduction appears to be pronounced even when economic growth is slow. It is also important to note that some countries have managed to improve equity even in periods of relatively slow growth by ensuring that whatever gains ensue from this growth accrue relatively more to the poorer segments of the population (Pasha and Palanivel, 2004). This highlights the importance of Egypt's social spending. However, could this social spending be more focused and better targeted through direct income supports, perhaps with conditions related to school attendance and use of local clinics? Strategies addressing income redistribution must be fiscally sustainable and it is unclear that Egypt's policies are. And high inflation, which has again appeared in Egypt, is likely to cause an increase in poverty (Agenor, 2002).

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2.8 CONCLUSION

This chapter has presented the economic achievements of the past year along with the remaining significant challenges. These challenges are both macroeconomic in nature (budget deficit, inflation, debt) and structural. Of utmost importance in coming years will be designing and implementing a long term strategy based on the drivers discussed above.The strategy must also include policies that address growth and equity by contributing to rapid employment growth, agriculture sector growth and social development, perhaps with more efficient and targeted supports to lower income groups.The Egyptian National Competitiveness Strategy must also be a pro-poor economic growth strategy.

Despite high economic growth, there is an urgent need to address growth that affects the poor by addressing the remaining macroeconomic challenges and moving much more aggressively into implementing a comprehensive national competitiveness strategy in which all relevant ministries take ownership. The public and private sector leadership must be cognizant of the data that indicate Egypt's overall business environment remains behind that of many other countries.

Given sufficient determination and political will, Egypt's competitiveness rankings will improve in the years to come. For its part, ENCC will continue to benchmark and measure progress in these areas, while supporting private-public dialogue aimed at finding creative solutions to increasing Egypt's competitiveness. For a deep-seated economic recovery to be sustained. good economic governance must be institutionalized and the private sector must become more assertive with its reform demands to help overcome the piecemeal and gradual approach.

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3. Doing Small Business

Author: Dahlia El-Hawary[1]

3.1 A PROFILE OF THE SME SECTOR IN EGYPT[2]

The importance of the small and medium enterprise (SME) sector is reflected in the size of its contribution: it accounts for 75 percent of employment, 80 percent of GDP and 99 percent of the non-agricultural private sector in Egypt.[3] There have been more than 150 entities that provide technical and financial assistance as well as service delivery to this sector. However, these efforts have been scattered and largely uncoordinated, which has curtailed the sector's growth potential.

The Government recently issued the Small Enterprise Development Law (Law 141/2004) that designates the Social Fund for Development (SFD) as the key institution orchestrating the development of the sector by ensuring coordination between firms, ministries and various donor agencies. Specifically, the mandate of the SFD is to provide micro and small enterprises with both technical and financial services to support their establishment, operation and growth.[4] Yet the sector still faces many challenges, as evidenced by its limited contribution to the economy, accounting for only 4 percent of exports and 10 percent of fixed capital formation.[5]

The objective of this chapter is neither to provide an assessment of all of such challenges, nor to give a comprehensive review of the evidence on the importance of the sector or its potential contribution to the economy, as these aspects have already been covered in previous works. The discussion rather focuses on some of the issues associated with access to finance and the regulatory burden that small and medium entrepreneurs have to deal with in doing their business. It also sheds light on some of the key drivers to growth of the sector and their current status in Egypt. The discussion is based on the premise that the SME sector has a disproportionate share of impediments compared to large enterprises. It is limited to small and medium businesses employing more than four workers, as micro enterprises are more of a reflection of survival strategies and are better targeted through social safety nets and microfinance programs.

Recent data document the increased number of smaller sized firms and their growing contribution to employment in the economy. Based on the results of the most recent Egyptian Labor Market Survey (ELMS) of 2006, it is estimated that the number of businesses employing fewer than 50 workers has

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[1] Mohamed Abdel Aziz, Manager of SME Development Unit/SMEPol Project at the Ministry of Finance, provided valuable inputs to this chapter.

[2] Up-to-date national data on the SME sector in Egypt are not readily available. The establishment census conducted by the Central Agency for Public Mobilization and Statistics (CAPMAS) is carried out every 10 years. The last one was conducted in 1996, and the new census is expected to be published by the end of 2007.

[3] See AfDB/OECD (2005).

[4] The SFD offers firms non-financial incentives including the provision of 10 percent of the land in industrial and tourist development zones. The SFD has also established a special SME unit in each of the 26 governorates to expedite the establishment of firms using temporary licenses. It also provides firms with technical support related to feasibility studies, information about marketing, risks, equipment and suppliers. As for financial services, the SFD provides firms with credit at advantageous interest rates. See AfDB/OECD (2005).

[5] See Ministry of Finance, MOF (2004).

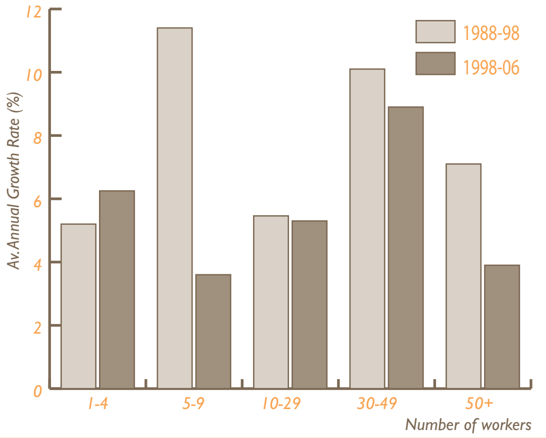
increased at an annual rate of 4.7 percent over the 1998–2006 period, and that total employment at these businesses represents about 39.5 percent of the Egyptian workforce in 2006.[6] Table 3.1 shows that the fraction of private non-agricultural wage-workers in businesses employing more than four but less than 50 workers has increased from 20 percent in 1988 to about 30 percent in 2006. It also shows that employment in larger sized firms, with more than 50 workers, has not grown in relative terms.[7]

Table 3.1: The Size of Enterprises Employing Private Non-Agricultural Wage-Workers in 1988, 1998 and 2006

Number of Workers	Employment (%) 1988	Employment (%) 1998	Employment (%) 2006
1-4	45	48	50
5-9	9	17	14
10-29	9	10	10
30-49	2	4	5
50+	13	16	15
Don't' Know	22	6	6
Total (%)	100	100	100
Total in thousands	2,546	3,995	6,430

Source: El-Mahdi and Rashed 2006, based on ELMS 2006.

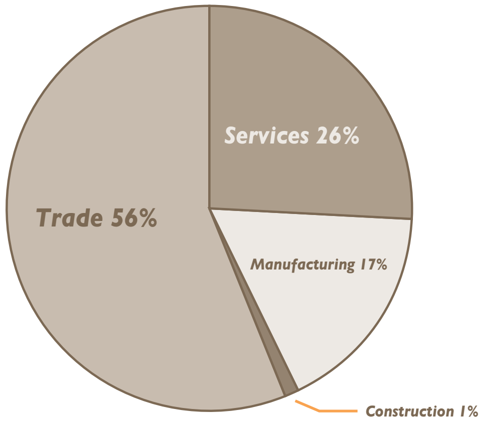
FIGURE 3.1: GROWTH OF PRIVATE NON-AGRICULTURAL WAGE EMPLOYMENT BY FIRM SIZE



Source: Asaad 2006.

Figure 3.1 also shows that employment in businesses employing between 30 and 49 workers has been the fastest growing segment of the private non-agricultural sector over the 1988–2006 period. This is followed by fast growing employment in businesses employing fewer than five workers.[8]

FIGURE 3.2: MSMES BY SECTOR



Source: CAPMAS 1996.

Figure 3.2 shows that the distribution of micro, small and medium enterprises (MSMEs) is mostly concentrated in the trade sector followed by service activities including hotels, real estate, education and health. This is followed by the manufacturing and construction sectors.

[6] See El-Mahdi and Rashed (2006).

[7] Private non-agricultural wage work represents about 65 percent of private non-agricultural employment and 30 percent of total employment in Egypt. See El-Mahdi and Rashed (2006).

[8] See Asaad (2006).

3.2 CONSTRAINTS TO GROWTH OF SMES IN EGYPT

In assessing the ease of SME doing business in Egypt, the World Bank has singled out three factors that account for the country's underperformance: getting credit, dealing with licenses and enforcing contracts. In this section, we shall focus on these constraints with reference to difficulties on the legal front.

3.2.1 Access to Finance

Limited access to finance and the absence of financial services specifically tailored to the needs of SMEs have inhibited their growth in Egypt.[9] Evidence shows that Egyptian firms have little recourse to external sources of funding in general and specifically to bank credit. This has been documented in a recent World Bank Investment Climate survey where firms identified both access to finance and its cost among the top ten constraints impeding their investment and growth.[10]

In a recent evaluation of the effect of public sector reform on privatized firms, evidence on limited access to banking finance is documented as shown in Table 3.2. The findings show that retained earnings represent 56 percent of the new investments made by these firms, whereas the contribution of bank credit stands at less than 40 percent, of which public banks accounted for 13 percent and private banks for 26 percent. One third of the surveyed firms have indicated difficulties borrowing from banks due to the required conditions and credit guarantees.[11]

Table 3.2: Sources of Investment Finance for Privatized Firms

Source of Finance	Relative Share (in percentage)
Public Banks	13
Private Banks	26
Self-Finance	56
Share Issuance	0
Other	5
Total	100

Source: El-Mahdi 2007.

It is estimated that banks and financial institutions provide only about 20 percent of new investment finance in Egypt. Specifically, it is reported that over 80 percent of new investments undertaken by Egyptian firms is financed internally through retained profits while less than 10 percent is sourced from the banking sector, and less than 20 percent of surveyed firms have some form of loan from a financial institution. The picture on access to formal channels of finance is even more pronounced across firms of different sizes, where only 17 percent of surveyed firms operate in the formal credit market, with the proportion standing at 13 percent of small firms and 36 percent for larger ones.[12] Other sources show that 78 percent of small firms have never applied for a bank loan, and that 92 percent of those that have applied were rejected.[13]

Table 3.3: Sources of Initial Capital by Size of Enterprise

Sources of Initial Capital	One Worker	2 to 4 Workers	5 to 9 Workers	10 to 49 Workers	Total
Inheritance	22	19.1	33.3	30	21
Own Savings	63.3	70.7	61	64.2	67.1
Liquidation of Assets	5.1	2.5	0.7	4.2	3.6
Formal Loans	3.2	4.1	0.7		3.5
Informal Loans	3.5	2.2	0.7		2.6
Own Remittances	0.4	0.5	2.1		0.5
Other Remittances	1.2	0.6	0.7		0.9
Other	1.3	0.3	0.7	1.7	0.8
Total Number	2107	2579	141	120	4947

Source: ERF 2005.

A recent survey by the Economic Research Forum (ERF) shows that formal loans do not represent more than 3.5 percent of the main sources of financing initial capital for those businesses employing fewer than 49 workers. Similarly, informal loans play a limited role, contributing only 2.6 percent of the

[9] It is well documented that smaller firms face higher financing constraints than their larger counterparts due to a number of reasons affecting their access to sources of external finance. First, smaller firms do not own sufficient assets that need to be collateralized to be able to borrow from banks. Second, they are likely to find it more costly to raise external funds through new share or bond issuance as the transaction costs are inversely related to a firm's size. Third, they lack access to political connections or networks that are usually available to larger firms. Fourth, small firms may be considered to be more "informationally" opaque than larger ones as they may not have established long track records so that creditors may find it more difficult to collect and to analyze the information necessary to assess their performance. See Love (2003).

[10] About 30 percent of surveyed firms perceive that both access to finance and its cost present major constraints to their investment. The survey was conducted in 2004. World Bank (2004a).

[11] The results of the evaluation are based on a random sample of 23 public sector enterprises that were privatized over the 1991–2006 period. See El-Mahdi (2007).

[12] World Bank (2006).

[13] This is based on a survey conducted by Small and Medium Enterprise Policies (SMEPol), a joint project of the Egyptian and Canadian Governments, AfDB/OECD (2005).

sources of initial capital.[14] Entrepreneurs rely mainly on their own savings or inheritance, which represent 67 percent and 21 percent of their initial capital respectively, as shown in Table 3.3.[15]

Table 3.4 shows the distribution of the various sources of credit by the size of businesses employing fewer than 49 workers over a 12-month period. Formal loans are mostly offered to larger sized businesses employing between 10 and 49 workers, while informal loans mainly serve firms of smaller size. The latter type of loans obtained from family members, friends and neighbors represent about 30 percent of the sources of credit available to businesses, while banks and the SFD provide only 42.6 percent and 10.8 percent of these sources respectively.

Table 3.4: Sources of Credit by Size of Enterprise Over a 12-Month Period

Sources of Loans	One Worker	2 to 4 Workers	5 to 9 Workers	10 to 49 Workers	Total
Bank	23.6	55	80	100	42.6
SFD	8.2	13.7			10.8
Domestic NGO	8.2	3.1			5.2
Government Agencies	0.9				0.4
Family	12.7	4.6	20		8.4
Friends	16.4	4.6			9.6
Neighbors	10	9.2			9.2
Business Associates	19.1	7.6			12.4
Other	0.9	2.3			1.6
Total Number	110	131	5	5	251

Source: ERF 2005.

Access of the SME sector to sources of external finance, and especially to bank credit, has been influenced by both credit supply and demand factors. There is also the instrumental role of the different pillars of the institutional environment in shaping the relationship between borrowing SMEs and finance providers. These include, but are not limited to, the efficiency of the legal system ensuring contract enforcement and loan repayment as well as the presence of well functioning credit information bureaus reducing the information asymmetry that typically exists between borrowers and lenders in financial markets. This is in addition to the importance of a well developed financial system providing SMEs with alternative sources of finance, hence creating an efficient source of competition to the banking sector.

It can be argued that Egyptian banks have generally been overcautious and have developed a kind of risk aversion in lending out as a result of the non-performing loan build-up that took place over the last two decades. The banking sector has significantly reduced its net claims on the business sector over the 2002–2005 period, while it more than doubled its exposure to the Government sector, including the Central Bank of Egypt, from 10 to 25 percent of GDP.[16]

The declining exposure to the private sector reflects banks' current preference to hold alternative assets instead of lending out to the business sector. The preferred assets have more favorable risk/return characteristics, and include government securities, Central Bank deposits and foreign assets. In that respect, weakened private credit growth, declining from 11 percent in 2001/2002 to about 6.8 percent in 2005/2006, may inhibit the expansion of the business sector in general.[17] This would be particularly harmful to the development of SMEs as they are subjected to higher financing constraints on access to funds necessary for their establishment, operation and growth.

The Government has recently made significant progress in reforming and strengthening the banking sector.[18] However, the effects of the long legacy of public sector ownership of banks in Egypt are still felt as it has negatively affected the efficiency of financial intermediation and resource allocation mechanisms. Specifically, state ownership of banks has significantly influenced the direction of credit towards public sector entities, and has resulted in operational deficiencies for the banking sector as a whole. It has also limited the development of risk assessment skills and management capabilities within the sector.[19]

It could be argued that state ownership has created a weak credit culture characterized by risk aversion on the part of suppliers of finance.[20] In other words, the prevailing culture has resulted in the underdevelopment of skills necessary for lending out based on

[14] Informal loans are obtained from family members, friends or neighbors. See ERF (2005).

[15] This is based on the findings of a recent survey by El-Mahdi et al. (2005), "MSEs Potentials and Success Determinants in Egypt 2003–2004: Special Reference to Gender Differentials," the Economic Research Forum for the Arab Countries, Turkey & Iran in 2005, referred to hereafter as ERF (2005).

[16] The Central Bank of Egypt has restructured about half of outstanding private sector non-performing loans (NPLs). See IMF (2006).

[17] IMF (2006).

[18] Reforms include, but are not limited to, divesture of the stake of the state in most joint venture banks as well as the sale of Bank of Alexandria, which is one of the four state-owned banks in Egypt. This is in addition to reforms aiming at improving the performance of the banking sector with a focus on its soundness, profitability and stability. To that end, reforms have been undertaken to restructure non-performing loans, to improve managerial and human resource skills, and to raise banks' profitability. See IMF (2006).

[19] See World Bank (2006).

[20] Some credit officers have explained that borrowers' defaults may expose them to suspicion of corruption and may expose them to the risk of criminal charges for wasting public assets. See World Bank (2006).

borrowers' creditworthiness, and hence has created a lending bias towards larger and more mature firms with sufficient collateral. It is estimated that the value of the collateral required represents about 130 percent of the loan to be extended. This is an issue that may raise the question of whether banks may be heavily using collaterals as substitutes for conducting an efficient screening of their potential borrowers.[21]

Difficulties with collateral valuation, high registration fees and lengthy procedures have made it more difficult for SMEs to collateralize their assets, and this in turn has weakened financial institutions' incentives to lend out to the sector. Problems of contract enforcement also affect SMEs' access to finance as a result of slow loan recovery procedures. Repossession of immovable collateral can take up to eight years for court approval and public sale.[22]

The World Bank (2004a) shows that 24.7 percent of surveyed firms identify the legal system and conflict resolution as a major constraint to investment in Egypt with only 24.3 percent of firms using courts to resolve disputes.[23] The proposed establishment of specialized economic courts represents a major step for reducing red tape and improving the judicial framework governing business contracts.[24] This is expected to improve the quality and the speed of court decisions by providing judges with the necessary knowledge on credit risks and financial markets.

There are also important factors on the demand side hindering the access of the SME sector to finance. Specifically, banks have generally complained about SMEs' lack of the financial management skills necessary to develop credible investment plans that largely influence their level of creditworthiness. In that respect, the lack of reliable market information makes it difficult for SMEs to develop sound business plans. Poor accounting records, lack of transparency, non-compliance with information disclosure standards and an absence of corporate governance represent major impediments to lending to the SME sector.[25]

3.2.2 *The Regulatory Burden*

Excessive regulation can be harmful to the competitiveness of any economy, its growth and prosperity. It is most harmful to the development and growth of the SME sector due to the high cost of compliance in terms of time, money and lack of transparency causing confusion and uncertainty.[26] Regulation is not costless. Yet, there is generally a lack of recognition on the part of the regulators of the negative effect of the regulatory burden on the development, productivity and competitiveness of the SME sector. Excessive regulation may act as a hidden tax on doing business in the economy and it is usually difficult to provide an accurate estimate for the cost of the regulatory burden in inhibiting the development of entrepreneurship, in wasting the opportunity to create new jobs in the economy and in fueling the informal sector.[27]

As mentioned in Chapter 1, the World Bank (2007) has ranked Egypt poorly among 175 countries in terms of the ease of doing business.[28] Specifically, Egypt's respective ranks are 125th, 169th, 157th, 144th, 141st and 120th as related to starting a business, dealing with licenses, enforcing contracts, employing workers, registering a property and closing a business. On average, it takes an entrepreneur ten procedures and 19 days, and costs about 68.8 percent of per capita income to start a business in Egypt compared to only 6.2 procedures, 16.6 days and only 5.3 percent of income per capita in the OECD countries.[29]

As for dealing with licenses, it takes about 30 procedures and 263 days to obtain the required licenses and it costs about 1,002 percent of per capita income compared to only 14 procedures, 149.5 days and 72 percent of per capita income in the OECD countries. Based on World Bank (2007) estimates, the Egyptian labor market has suffered from rigidities in firing workers with the associated costs reaching about 186 weeks of wages as compared to only 31.3 and 56.9 weeks in the OECD countries and in the MENA region respectively. In order to secure rights to property, it takes on average about 193 days to register a property in Egypt compared to only 31.8 days in the OECD countries and 49.9 days in MENA.[30]

It is also time-consuming and costly to close a business in Egypt due to weaknesses in the current bankruptcy law as well as the procedural and administrative bottlenecks in the exit process. According to the World Bank (2007), it takes an average of 4.2 years to close a business and costs about 22 percent of the value of estate with only about 16.6 cents on the dollar being recovered from the insolvent firm. These numbers compare poorly to both the MENA

[21] World Bank (2006).

[22] World Bank (2006).

[23] The World Bank Investment Climate Assessment survey was conducted in 2004.

[24] IMF (2006).

[25] Some bankers noted that some SMEs maintain double accounts for different purposes.

[26] See Taylor (2003).

[27] Jones, L., et al. (2005).

[28] This is based on the World Bank Report (2007) "Doing Business: How to Reform?"

[29] See World Bank (2007).

[30] See World Bank (2007).

region and the OECD countries: in the MENA region it takes 3.1 years to close a business, and costs 12.1 percent of the value of the estate with about 25.7 cents on the dollar being recovered; In OECD countries, the respective figures are 1.4 days and 7.1 percent of the value of the estate, with about 74 cents on the dollar recovered from the ailing firm.[31]

It should be noted, however, that the methodology used in the World Bank *Doing Business Report* (2007) has its own limitations. It has been challenged by a number of countries, which has led to a number of corrections. For Egypt, while some of the information may be correct, other parts have proved to be inaccurate as a result of misreporting, use of different terminologies or subjective evaluation based on value judgment and personal estimates. For instance, the Ministry of Housing refuted the time reported to obtain a license (263 days) and noted that such time never exceeds four weeks. Similarly, Labor Law 12/2003 specifies that severance pay for workers with 20 years of service is 160 weeks of wages, not 186 weeks as reported. The law also regulates firing, and legally authorizes the termination of work under certain conditions including redundancy.[32]

Egypt's ranking by the World Bank *Doing Business Report* (2007) has received due attention by the Government. Communication channels with the Doing Business team have been established to voice Egypt's concerns about the methodology underlying the ranking and to update the team with all reform efforts that were undertaken but not adequately reflected in the 2007 report. The Ministry of Investment also established a working group, representing the entities dealing with the various aspects of doing business in Egypt and including intermediaries such as lawyers and accountants, to follow up, monitor and suggest further reforms. An assessment is currently under way on the ease of doing business at the governorate level in Cairo, Alexandria and Assiut.[33]

In general, it is estimated that 40–60 percent of the costs of doing business arise from the regulatory burden and that excessive regulation is fueling the informal economy in Egypt.[34] According to the ERF (2005), entrepreneurs noted that "Having to deal with public officials in the different central or local government offices was one of the common complaints. Misinformation, unwillingness to explain or discuss certain issues and refusal to accept the validity of accounts are all problems that account for the high prevalence of informality."[35]

A firm's decision to join the formal sector, and hence to comply with the legal and regulatory rules, is size-sensitive in Egypt just as it is in other parts of the world. The numerous problems that SMEs are facing to start up and to operate their businesses have created a disincentive for these entrepreneurs to formalize. The decision to move to the formal sector is largely determined by the trade-off between the costs of abiding by the regulations and the benefits associated with formality.[36] Specifically, staying informal deprives SMEs of the benefits of being able to apply for loans and/or acquire business development services (BDS), and thus limits their growth potential.[37]

The Egyptian Labor Market Survey of 2006 shows that both informal and formal private non-agricultural employment has been growing rapidly over the 1988–2006 period, as shown in Figure 3.3.[38] Informality does not necessarily reflect the inability of an SME to survive, grow or expand its business but rather the difficulty of joining the formal sector, thus denoting a case of rejection or inability to comply with costly and complicated rules and regulations.[39] As of 2006, evidence shows that the average age of an informal economic unit is about 12.1 years while that of a formal economic unit is 19.3 years.[40]

[31] World Bank Report "Doing Business: How to Reform" in 2007.

[32] Based on this law, Egypt should have been assigned a score of zero for the difficulty of firing index instead of 100, the latter score implying that firing regulations in Egypt are among the most restrictive. Had the score reflected the law, Egypt's score for the rigidity of employment index would have improved. Such recalculation would also improve Egypt's overall ranking from 165th to 154th. This is based on a recent detailed assessment by the Ministry of Investment, General Authority for Free Zones & Investment (GAFI), and concerned entities that carefully reviewed the various components of the World Bank ranking of Egypt's ease of doing business.

[33] This is based on a report by the Ministry of Investment and GAFI.

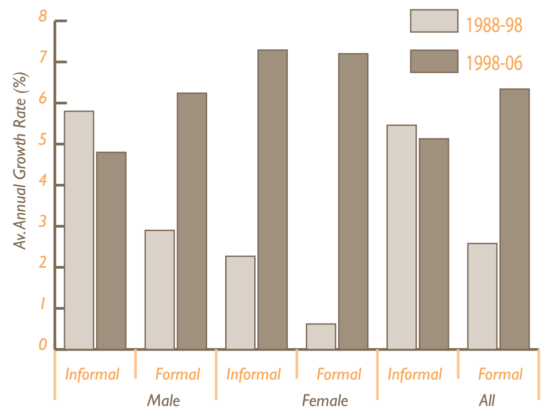
[34] This estimate is from the USAID/TAPR II (2006) report "Taking Care of Business."

[35] This is based on an ERF (2005) survey, covering about 5,000 enterprises that employ fewer than 50 workers. It presents evidence on the profile of informality of businesses in Egypt. The results reveal that less than 30 percent of the units surveyed are formal while the rest are operating on an informal basis. Formality is defined based on whether the unit is registered, has a license, and keeps regular accounts. It shows that 81 percent of surveyed units in rural areas are informal compared to 63 percent in urban ones. The findings also reveal that informality is highest among single-worker enterprises, representing about 83 percent of them, and declines as the number of employed workers increases.

[36] The Ministry of Economy and Foreign Trade (2002).

[37] According to Agyari et al. (2003), "Correlations indicate that countries where it is more costly to register a new enterprise have a smaller share of SMEs and a larger informal sector. This suggests that costly registration requirements constitute an impediment for informal firms to convert themselves to formal."

FIGURE 3.3: *THE GROWTH OF FORMAL & INFORMAL COMPONENTS OF PRIVATE NON-AGRICULTURAL EMPLOYMENT*



Source: Asaad 2006.

The results of the ELMS (2006) underline the stability in the degree of informality among smaller firms over the 1998–2006 period. Table 3.5 provides evidence on the distribution of formal and informal businesses by size of firm, measured by number of workers, in the years 1998 and 2006. It shows that informality declines with the size of the firm, and that most informal enterprises are concentrated among those employing fewer than five workers. Interestingly, the same trend holds for formal businesses.[41]

Table 3.5: The Distribution of Enterprises by Formality and Size

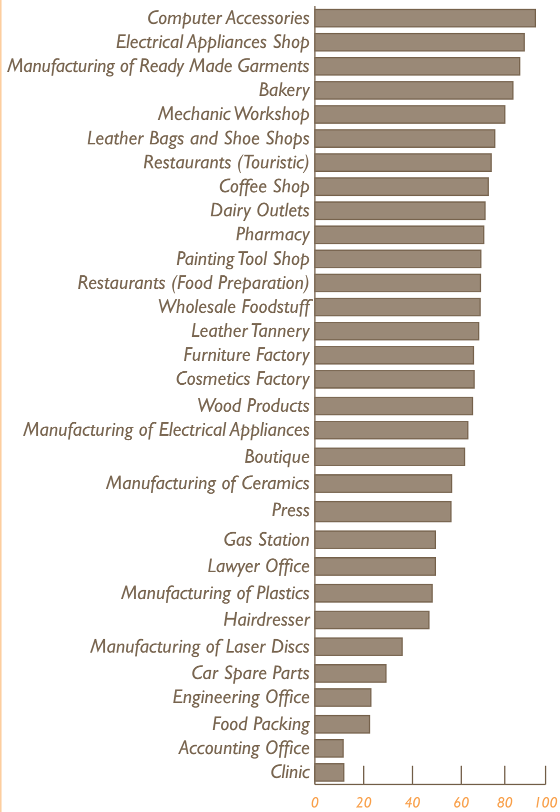
Number of Workers	2006			1998		
	% Formal	% Informal	% Total	% Formal	% Informal	% Total
1-4	89.8	96.3	95	74.6	94.6	91.3
5-9	7.6	3.3	4.2	16.4	4.6	6.5
10-29	1.6	0.3	0.6	6.9	0.6	1.6
30-49	0.9	0	0.2	1.1	0.1	0.3
50+	0.1	0	0	0.8	0.1	0.2
Total	100	100	100	100	100	100

Source: EL-Mahdi and Rashed 2006.

In comparison with larger firms, there is a disproportionate burden imposed on SMEs, which are hit the hardest by excessive regulations. By virtue of their size, small and medium businesses do not have the level of human and financial resources that their larger counterparts usually devote to compliance with regulations. For instance, while a large firm can dedicate an employee to dealing with the issue of regulatory compliance, this is quite impossible for a small firm employing around 10 people, as this would mean it was allocating 10 percent of its workforce to that purpose. Another reason is related to the inability of SMEs to pass on the cost of the regulatory burden in the form of higher prices to their customers, as they may lose their competitive edge.[42]

In 2002, an SME entrepreneur had to spend an average of 222 days before obtaining a license and establishment permits, and the duration could climb to almost 567 days for some activities. Evidence also shows that extralegal payments made by SMEs ranged from 15 percent to almost 90 percent of total payments made for licensing and establishment, as shown in Figure 3.4.[43] As an example of the high cost of regulatory compliance as a percentage of capital in Egypt, De Soto (2000) noted that in order to establish a bakery the total costs as a percentage of invested capital could reach 140 percent, and in some other sectors can even reach 165 percent.[44]

FIGURE 3.4: *PERCENTAGE SHARE OF EXTRALEGAL PAYMENTS IN TOTAL PAYMENTS FOR LICENSING & ESTABLISHMENT*



Source: Makary 2002.

[38] See Asaad (2006).

[39] See ERF (2005).

[40] See El-Mahdi and Rashed (2006).

[41] See El-Mahdi and Rashed (2006).

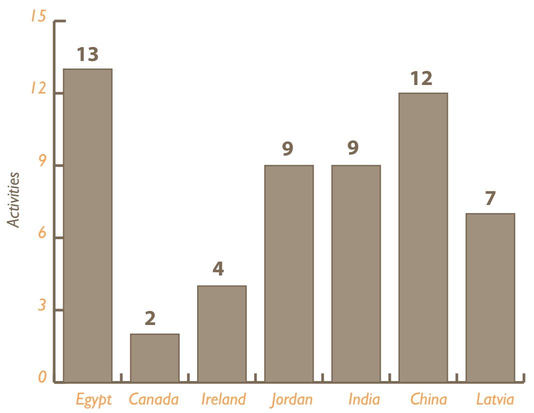
[42] In Canada, the cost of compliance with regulations decreases as the business size increases. See Jones, et al. (2005).

[43] See Makary (2002). Evidence on extra-legal payments made is based on sample surveys of SMEs operating in different sectors.

[44] de Soto, Hernando et al. (November 2000). "Informality in Egypt's Business Sector: Assessment and Preliminary Results." Presentation in Cairo. 45 See MOF (2005).

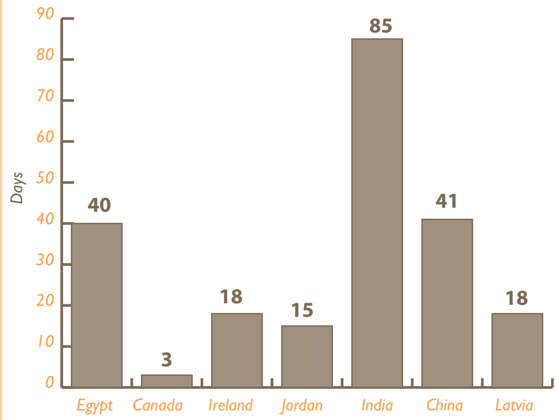
Comparing Egypt to other countries, Figures 3.5–3.7 illustrate the difference in terms of the number of activities, the time needed and the cost paid to establish firms, irrespective of their size, in six countries at different levels of development.[45] While the number of activities and the time needed to establish a firm in Egypt are similar to those in a country like China, evidence shows that the cost of establishing a firm in Egypt is more than the double of the cost incurred in China. This is also the case for the remaining countries as it costs more to establish a firm in Egypt than in any of the other benchmark countries.

FIGURE 3.5: NUMBER OF ACTIVITIES



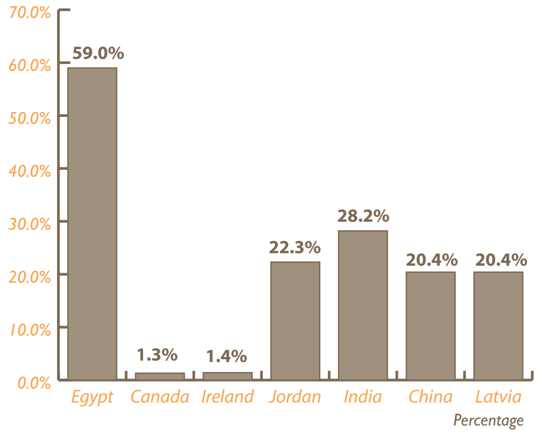
Source: Ministry of Finance 2005.

FIGURE 3.6: TIME FOR ESTABLISHMENT



Source: Ministry of Finance 2005.

FIGURE 3.7: COST TO ESTABLISH A FIRM AS A PERCENTAGE OF GROSS NATIONAL INCOME PER CAPITA[46]



Source: Ministry of Finance 2005.[47]

[45] See MOF (2005).

[46] Egypt's cost is US$ 820 (LE 5,095), using the exchange rate on 24/12/2004.

[47] The case used for comparison is that of establishing a regular limited liability capital company. See MOF (2005).

3.3 PAVING THE WAY OUT FOR SMEs

3.3.1 Improving Access to Finance

Many reforms have been undertaken to improve access to finance in Egypt. However, some of these reforms may not cater to the needs of the vast majority of firms constituting the SME sector. To reduce the severity of asymmetric information problems between borrowers and finance providers, the first Credit Information Bureau in Egypt has been established and will start its operations by July 2007.[48] *By making available reliable credit information, the Bureau is expected to enable the various lending institutions, including providers of leasing and mortgage finance services, to make better informed decisions about the creditworthiness of their borrowers and to promote credit demand in the economy. This is expected to significantly improve the access of SMEs to the various sources of finance by expanding lending opportunities and lowering borrowing costs as a result of reduced loan processing time and expenses.*[49]

To provide an alternative source of external finance for the SME sector, the Ministry of Investment has recently taken active steps to establish a new "stock exchange" especially for SMEs that cannot comply with the listing rules required in the main stock exchange.[50] The new financing venue is expected to improve SMEs' bargaining power when borrowing from banks. Other benefits include providing SMEs with fair market valuation for their businesses and an easy exit in case a firm would like go out of business. This is in addition to the accrued benefits associated with better transparency and information disclosure as a result of SMEs' compliance with corporate governance rules. In that respect, being listed in the new stock exchange will exert much needed pressure on SMEs to improve their organizational structure as well as their managerial and financial skills.

While the new stock exchange will provide a dynamic venue to support the growth of viable SMEs, it may not really cater to the needs of the vast majority of the sector, where firms need both financial and technical support during the stages of their life cycle, including the start-up phase. One of the key conditions for being listed in the new stock exchange is that the targeted firms have to be successful SMEs with strong potential to grow. To be listed in the first place, firms must have already achieved high quality production and good corporate governance.[51]

As part of the private equity industry, venture capital presents an innovative financing mechanism with management assistance for SMEs. It is still a young industry with about 13 registered firms in Egypt. It offers the early stage, high risk, high reward financing that start-up firms seek in order to establish and develop their businesses. The development of such an industry relies heavily on the presence of a dynamic entrepreneurial base with good business ideas, sources of funding and strong human resources with well trained and experienced staff in accounting and finance. This is in addition to the need for supporting institutions, including but not limited to universities, research organizations and service providers.[52]

In order to operate efficiently, the industry needs to be supported by viable liquidity and exit opportunities, which can be facilitated by the establishment of the new SME stock exchange. However, the current legal and regulatory environment may present a major impediment to the growth of the industry in Egypt. In that respect, Egyptian laws and regulations governing issues such as enforcement of intellectual property rights, structure of venture capital funds and shareholders' rights need to be brought in line with those used in major financial hubs like in Bahrain, Dubai, the United States and the United Kingdom.[53]

The transitional nature of venture capital may not be best suited for providing support to the vast majority of existing SMEs in Egypt. Specifically, venture capital providers seek quick turnaround of their funds by floating their shares in the market within a two- to three-year period, aiming at capital gains rather than profit-sharing in the investments they make in fast

[48] The Credit Information Bureau was established in partnership with the SFD and 27 banks with LE 30 million in capital. See *Al Ahram* (March 2007).

[49] See Egyptian Banking Institute, Seminar Series, Issue #10.

[50] For instance, while the capital required for listing SMEs is only LE 250,000, firms listed in the main market are required to have capital of LE 5 million. The new SME Stock Exchange is expected to be launched before the end of 2007. The development of SME stock exchanges began worldwide in the early 1970s, and there are currently about 37 stock exchanges for SMEs, with a market capitalization exceeding US$ 4 trillion. This information is from a presentation by Dr. Mohammed Omran, Vice Chairman of the Cairo and Alexandria Stock Exchange, on March 13th, 2007 in a seminar on "Financial and Non Financial Services in Promoting MSMEs in Egypt," sponsored by the Egyptian Banking Institute.

[51] An SME has to be supported by either an institutional sponsor or an institutional investor where the latter acts as a provider of private equity, a mechanism that is expected to boost investors' confidence in listed SMEs and to ensure transparency in the new market. The state may provide financial support to establish a fund that will cover most of the costs associated with the listing. In Tunisia, the state covers up to 37 percent of the costs of qualified sponsors. The sponsor will provide SMEs with services related to listing, share issuance and information disclosure for about three years. The sponsor will be held accountable to the Capital Market Authority for the performance of the SME and its compliance with the various listing rules during the period. (This information is from Dr. Omran's presentation as noted in the previous footnote.)

[52] There are several other venture capital firms operating in Egypt but registered elsewhere. See Miller (2006).

[53] See Miller (2006).

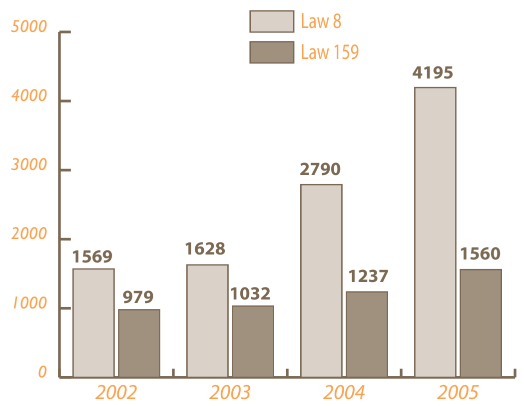
growing SMEs. In that respect, venture capital does not allow for an investment lock-up period in those firms that need a long growth period before they become marketable. Another important characteristic of venture capital is that it is not merely intended to act as a financier of the targeted firms but rather aims at actively participating in firm management by seeking ownership of the majority of shares. This consideration may be at odds with the nature of SME owners in Egypt, who may be reluctant to give up equity in return for investment. Based on field investigations, SME owners expressed no desire to relinquish equity in their businesses. It is to be noted that the vast majority of SME owners manage their enterprises.[54]

Leasing is another innovative mechanism that can provide SMEs with access to capital for investment through mid- to long-term financing.[55] It enables SMEs to benefit from technology transfer by focusing on the entrepreneur's ability to honor the lease payment rather than relying on credit history and subjecting him/her to strict collateral requirements. The industry is yet to be developed in Egypt, with the annual volume of leases and the number of leasing contracts still limited, partly due to lack of visibility on the part of leasing companies as well as lack of understanding of the nature of the industry on the part of entrepreneurs. These factors have limited the ability of the industry to reach its targeted clients, especially start-ups and SMEs.[56]

3.3.2 Regulatory Reform

The Government has made significant progress in reforming the regulatory environment related to doing business and investment. The General Authority for Free Zones and Investment (GAFI) has played a key role as the main facilitator and promoter of investment, transforming Egypt into an investor-friendly destination through process simplification, staff training and decentralization.[57] Data regarding FDI and the number of firms established document Egypt's success in improving the regulatory environment (see Figure 3.8) and in promoting FDI increasing from US$ 2.1 billion in 2003/04 to US$ 6.6 billion in late 2006 and US$ 7.2 billion in the first quarter of 2007.

FIGURE 3.8: THE NUMBER OF BUSINESSES ESTABLISHED BY INVESTMENT LAW



Source: Stone 2006.

In 2004, the Cairo One Stop Shop (OSS) was established in GAFI to provide investment-related services associated with the issuance of approvals, permits and licenses necessary to start up and operate businesses under Law 159/1981 and Law 8/1997. By 2006, GAFI managed to "deregulate" more than 40 start-up procedures, and to reduce the average time required to register a company from 34 days (up to 140 days) in 2001 to an average of three days.[58] Some start-up procedures, however, remain under the authority of other public entities. This is the case, for instance, with entities providing utility service connections. This provision remains slow, and constrains the establishment and operation of SMEs firms relative to larger ones.[59]

The Ministry of Investment has recently taken a significant step to encourage the establishment of SMEs by reducing the minimum capital requirement for limited liability companies incorporated at GAFI under Law 159/1981 from LE 50,000 to only LE 1,000. This step is expected to make it easier for SMEs to become formal and to gain access to sources of external finance.[60]

[54] This assertion is based on field investigations and interviews conducted by the Ministry of Finance and other entities. See MOF (2004).

[55] Leasing is a contractual arrangement that separates ownership from use, whereby an SME can use an asset in return for a periodic payment made to the leasing company that retains ownership of the asset. At the end of the lease contract, the entrepreneur can acquire ownership of the asset in return for a certain payment. See MOF (2004).

[56] The leasing industry was established in Egypt in 1995 by Law 95/1995, later amended in 2003. As of 2004, there were about LE 500 million new leases, and the number of leasing contracts reached 5,554, at a value of about LE 11.5 billion. See Nasr (2004).

[57] Prior to the establishment of the GAFI OSS in 2002, GAFI undertook a study of the regulatory procedures and bodies governing investment in Egypt. It concluded that a new investment could involve as many as 22 ministries and 78 government entities with time-consuming and inconsistent procedures. See Stone (2006).

[58] The idea of OSS is to bring officials from all relevant government entities into one place so that an investor can deal with them to obtain all the necessary documents in a simplified and coordinated process. In 2005, GAFI received 35,021 inquiries of which 27,452 were answered and 7,479 were referred to its advisory desk. See Stone (2006). GAFI also established three regional OSSs in Alexandria and Ismailia in 2005 and a third in Assiut in 2006.

[59] According to a recent World Bank survey of manufacturing firms, it took SMEs an average of more than 90 days to get a phone connection and more than 100 days to get electricity, while larger firms obtained their services much faster. See Stone (2006).

[60] See the website of the Ministry of Investment in Egypt (www.investment.gov.eg).

The SFD has established OSSs in six governorates: Giza, Alexandria, Minya, Assiut, Fayoum, and Beni Suef, to carry out the registration of micro and small firms. The have also started an initiative, Integrated Finance Centers, to make it easier for small entrepreneurs to register their businesses and to process their loan applications. OSSs along with Integrated Finance Centers are set up to assist start-ups, and SFD plans to establish such centers in each governorate so that entrepreneurs can meet the regulatory requirements to obtain their permanent licenses within a short time limit of 30 days. The Integrated Finance Center, located within the same complex as the OSS, will facilitate lending and non-lending activities for entrepreneurs.[61]

In spite of the efforts made by the SFD, questions have been raised about its degree of success in reaching out to its target clients. In a recent survey of small sized firms, all interviewed entrepreneurs noted their lack of awareness of the services provided by the SFD, especially those associated with registration, licensing and taxation.[62] This is an issue that highlights the urgent need to strengthen communication between the SFD and small firms in order to allow the latter to benefit from the variety of financial and non-financial services that the Fund can deliver.

OSSs have been set up to alleviate the burden of regulatory compliance facing SMEs, and they were initiated as early as the late 1990s. It should be noted, however, that the One Stop Shop is not an end in itself as reforms should not be limited to gathering all concerned entities in one location without simplifying the underlying rules and procedures. While OSSs are useful in reducing red tape and circumventing time and processes required to start up or to operate a business, they do not necessarily address long-standing problems inherent in the legal and regulatory environment associated with doing business in Egypt.[63] That is why a bold regulatory reform

BOX 3.1: Current Laws Governing the Establishment of Firms in Egypt

To better understand the reforms made by the Government on the regulatory front, it is important to shed light on the laws governing firm establishment in Egypt. There are two main categories of companies in Egypt, Individual (Partnership) and Capital. There are four enacted laws that regulate establishment of companies according to their type. The firm types and laws are:

- **Individual (Partnership) Companies (governed by Law 17/1999).**
- **Capital Companies (governed by Law 159/1981).**
- **Investment Companies, Individual (Partnership) and Capital (governed by Law 8/1997).**
- **Small and Micro Enterprises, Individual (Partnership) and Capital (governed by Law 141/2004).**

There are different government entities responsible for issuance of licenses according to these laws:

- **The Primary Court and Commercial Registry is responsible for registering regular Individual Companies (Law 17/1999).**
- **The Sector of Capital Companies (within GAFI) is responsible for registering regular Capital Companies (Law 159/1981).**
- **GAFI is responsible for registering Investment Companies (Law 8/1997).**
- **The Social Fund for Developmentis responsible for registering medium and small enterprises (Law 141/2004).**

[61] Under this arrangement, representatives of the SFD, intermediary banks and the Cooperative Insurance Society share an office and process the loan application submitted by the entrepreneurs for approval within a limited number of days of submission.

[62] See El-Nakeeb (2007).

[63] The Mansoura OSS, established in 1999, was one of the first attempts to address such burdens facing SMEs. It succeeded in reducing the numbers of days needed to issue licenses from an average of 365 days to an average of 20. See Brown and Fahmy (2005).

should be carried out in parallel to tackle deeper issues by streamlining regulations and improving their implementation at the national and regional levels.[64]

The scope of the reform process should be more comprehensive and should not be implemented in a piecemeal approach.[65] Some reforms may tend to address regulations/procedures that are not high on the priority list of regulatory reform, dealing with front-end issues while neglecting back-end ones because it is easier and faster to do so. In other words, quick measures may address 80 percent of the regulations/procedures that cause 20 percent of the problems whereas the crucial 20 percent of the issues that cause about 80 percent of the problems, creating the bulk of the regulatory burden which entrepreneurs face in doing their businesses, may be left unaddressed.

BOX 3.2: Examples of Reform Efforts at the Policy Level

In 2005, the Ministry of Finance, with the support of the Small and Medium Enterprises Policy Development Project, funded by CIDA, published a study on "Streamlining Egyptian Laws, Regulations and Procedures Governing SMEs' Establishment, Growth, Export and Exit." The study examines all laws and regulations that SMEs have to comply with and suggests an action plan to simplify such laws and regulations. Recommendations related to the SME establishment phase include but are not limited to: consolidating all laws governing establishment of enterprises in one law with processes done in one authority; having a unified national number for enterprises; adding the provision of "silence is consent" for getting government agencies' approval within a predetermined time period; and checking enterprises' names electronically to obtain approval from the commercial registry. Effective cooperation and coordination among government agencies and follow-up mechanisms are essential to implement the recommended actions that are expected to significantly reduce the time and cost of establishment.

[64] Many reform initiatives have been undertaken at the regional level in cooperation with the donor community. These include but are not limited to the IFC working with GAFI and the Governorate of Alexandria to reform the business environment in Alexandria. Beginning next May, the Smart Service Business Center (SSBC) will help small entrepreneurs start their businesses in Alexandria in cooperation with the Governorate and USAID. SSBC services are not limited to front-end issues related to dealing with entrepreneurs. They also involve working closely with a Red Tape Reduction Task Force at the Governorate in consultation with representatives of the small business community in Alexandria.

[65] For instance, the Governorate of Cairo, in cooperation with the Ministry of Administrative Development, recently established an Electronic Center in the district of Maadi to provide services for both citizens and investors. A problem still remains in that a small entrepreneur has to prepare a pile of paperwork to submit to the Center in order to get his license to start up his business. Employees at the Center explained, however, that an entrepreneur can get his business license in two weeks maximum, provided that he has all the needed paperwork ready.

3.4 DRIVERS OF GROWTH FOR THE SME SECTOR

Other factors have also played an important role in influencing the performance of the SME sector and limiting its potential contribution to the economy. In order to move up the competitiveness ladder, whether in the domestic or global market, efforts should be made to upgrade R&D and technological innovation, to continuously improve production processes and output quality and to develop a multi-skilled base of human resources. This section presents an overview of some of key drivers to growth of SMEs and sheds light on their current status in Egypt.

3.4.1 Innovation and Technology[66]

Results of the ERF (2005) survey reveal the modest level of the technology that small businesses generally use, as shown in Table 3.6. They usually rely on primitive, traditional techniques that curb their competitiveness, efficiency and ability to develop and to expand their business; only a minority of enterprises are able to use the latest technology.[67]

Table 3.6: Types of Technology Used Based on Different Criteria

Variable	Classification	Traditional	Modern	Up-to-date	Total
Area	Urban	80.4	16.3	3.3	3,060
	Rural	90.4	8.2	1.3	1,867
Region	Metropolitan	73.6	21.2	5.2	1,718
	Lower Egypt	92.9	6.4	0.7	2,118
	Upper Egypt	84.1	14	1.9	1,090
Gender	Male	83.6	14	2.4	4,318
	Female	88.4	8.1	3.5	608
Number of workers	1 Worker	90.4	7.9	1.7	2,091
	2–4 Workers	82.2	15.4	2.4	2,579
	5–9 Workers	59.8	32.2	8	141
	10–49 Workers	46.1	37.9	16.1	115
Value of Assets in LE	<1,000	95.6	3.5	1	807
	1,000 to <5,000	88.3	10	1.6	1,790
	5,000 to <20,000	80.8	16.6	2.6	1,358
	20,000 or more	71.9	22.6	5.4	971
Economic Activity	Industry	74.8	22.3	2.9	779
	Trade	88.5	9.4	2.2	3,182
	Services	77.7	18.8	3.5	965
Formality	Informal	89.4	9.6	1	3,460
	Formal	72	21.9	6.1	1,456

Source: ERF 2005.

It should be noted that demand constraints have been ranked by entrepreneurs as a top constraint on the development of their businesses in both rural and urban areas. They explained that decrease in demand for the goods and services they produce leads in turn to significant decline in their sales and profits and to a corresponding decrease in their workforce, wages or both. It is interesting to note that SME owners did not attribute this demand reduction to factors such as the lack of technological upgrading. This in itself reflects their inability to make the link between innovation, research and technology on the one hand and expanding their market share on the other.[68]

In general, R&D has not been an investment priority for SMEs as they may not fully cover their costs. Governments worldwide have played an important role in correcting this market failure by providing financial support to promote technological innovation. For instance, the Small Business Innovation Research (SBIR) program in the US allocates about four percent of the research budget of major institutions to fund innovative small enterprises. Similarly, the SMART scheme in the UK provides grants to SMEs for feasibility studies in innovative technology and for the development of new products and processes. Successful SMEs receive 75 percent of the eligible project cost. The UK also uses another scheme to foster collaboration between businesses and research institutions, where up to 50 percent of finance is offered to research projects in certain sectors to enhance their competitiveness.[69]

While R&D centers, technology transfer centers and quality control facilities can play a key role in disseminating information, identifying technological needs and purchasing, and ensuring proper technology transfer and its adaptation, there is a need to ensure the presence of an adequate absorptive capacity within the economy to acquire, adapt and assimilate new technologies.[70] This raises the importance of establishing a well developed scientific and educational base in the economy.

[66] Recent field investigations have identified a strong need for SMEs to upgrade their machines and their production processes, most of which date back to the 1970s or earlier. With minor exceptions, none of the enterprises examined had any R&D activities of any scale. Entrepreneurs expressed that they prefer using old technologies rather than dealing with the risk of adopting the latest ones, and therefore locally produce new machines that are similar to older ones. Additional reasons for using old technologies included the lack of perceived need, lack of awareness, low market absorptive capacity, shortage of finance, scarcity of qualified workers and unavailability of maintenance services. See MOF (2004).

[67] ERF (2005).

[68] See MOF (2004).

[69] These include electronics, communication & IT and food & agriculture. See MOF (2004).

[70] See MOF (2004).

3.4.2 Labor Force

Egypt has suffered from a serious knowledge gap, with the adult illiteracy rate standing at about 45 percent, surpassing that of Sub-Saharan Africa. In developed economies, there is an inverse relationship between unemployment and educational attainment. In the OECD countries, for instance, the average unemployment rate for those with lower secondary education is 10.5 percent but it is only 3.8 percent for those holding university degrees. Nevertheless, evidence documents a converse relationship in Egypt, with 1 percent of the illiterate suffering from unemployment whereas 32 percent of those with intermediate education and 19 percent of university graduates are unemployed.[71]

Such evidence raises concerns about the quality of the educational system as well as the relevance of the existing labor force to rapidly changing market needs.[72] It also sheds light on the negative impact of the current status of the labor force on the competitiveness of the economy, given the increased importance of knowledge and technology based production and the declining significance of low-skilled workers. Table 3.7 illustrates the findings of the ERF (2005) survey of about 5,000 SMEs, showing that the average years of schooling completed by entrepreneurs is only about eight, with female entrepreneurs reaching just 5.7 years.

The Egyptian economy has traditionally competed in labor-intensive manufacturing industries, and long relied on cheap abundant labor to maintain its competitive advantage in the world market. However, such advantage has been recently eroded with other developing countries, such as Romania, having labor costs estimated at half the Egyptian level. This is in addition to the effect of low labor productivity, estimated to be less than one sixth of that of Korean and Argentinean workers, in reducing the competitiveness of Egyptian products. It should be also noted that low skilled workers can negatively affect how efficiently other factors are utilized. For instance, it is estimated that the productivity of imported capital in Egypt is half its level in the country of origin as a result of low skilled labor.[73]

Table 3.7: Entrepreneurs by Number of Years of Education

Number of Years of Education	Percentage
Illiterate	24
1-6 years	17.9
7-9 years	10.1
10-12 years	30.2
13-16 years	17.4
17 years or more	0.4
Average number of years of education	8.1
Total number of entrepreneurs	4,959

Source: ERF 2005.

Table 3.8 indicates the distribution of male and female entrepreneurs who have had access to training by area, region, number of workers, value of assets, type of economic activity and formality of their business. In general, the figures show that training is offered on a limited scale to firms of smaller sizes, access to training is higher in metropolitan areas and lower Egypt, and it is more associated with owning or running larger businesses. The table also shows that female entrepreneurs are disadvantaged relative to their male counterparts, and that entrepreneurs engaged in formal businesses have had more training than those involved in informal activities.

[71] The adult illiteracy rate in East Asia and the Pacific region is 14.7 percent. It is 12.2 percent in Latin America and the Caribbean. See MOF (2004).

[72] An EU assessment of the Egyptian labor force found that graduates tend to have low caliber skills in spite of the large number of graduates and the extensive vocational training system existing in Egypt. See MOF (2004).

[73] See MOF (2004).

Table 3.8: Access to Training by Entrepreneurs Based on Different Criteria

Criterion	Classification	Male		Female	
		% with access to training	Total Number	% with access to training	Total Number
Area	Urban	34.7	2725	13.9	350
	Rural	26.7	1617	5	266
Region	Metropolitan	35.2	1539	14.2	190
	Lower Egypt	34.6	1828	7.8	308
	Upper Egypt	21	975	9.1	118
Number of Workers	1 Worker	23.6	1751	5.2	359
	2–4 Workers	37.1	2348	14	239
	5–9 Workers	43.5	131	46.1	11
	10–49 Workers	32.3	113	73.3	6
Value of Assets in LE	<1,000	25.9	617	1.2	202
	1,000 to <5,000	32.6	1591	12.1	202
	5,000 to <20,000	30.7	1231	13	137
	20,000 or more	35.7	903	22.8	75
Economic Activity	Industry	59.6	767	44.5	14
	Trade	23.4	2682	5.1	526
	Services	32.9	893	37.8	76
Formality	Informal	30.4	3041	4.4	444
	Formal	34.9	1292	24.7	171

Source: ERF 2005.

Results of the ERF (2005) survey also indicate that the majority of workers or entrepreneurs receive their training either on the job or through knowledge transfer across generations at the workplace. However, owners of SMEs have indicated their dissatisfaction with the lack of training facilities outside of the workplace, and the existing training system limits both owners and workers' ability to acquire specialized skills related to innovation and technological upgrading. As a result, enterprises continue to rely on outdated technology and skills, thus inhibiting both their growth and ability to compete.[74]

To empower the workforce and enable it to play a significant role in improving the competitiveness of the Egyptian economy, the educational system needs to be reformed in order to promote entrepreneurial skills, innovation and learning. Such reform is also of extreme importance to create and maintain a better match between market needs and labor supply. This would require a significant but quite worthy investment of resources in reforming the educational system to close the knowledge gap between Egypt and the rest of the world.[75]

3.4.3 *Business Development Services*

Business development services (BDS), associated with training, input supply, information, marketing, product development and technology, have been criticized in most developing countries for being supply-driven by government agencies without really addressing the actual needs of SMEs. BDS have been characterized by poor planning, weak management, bureaucracy, lack of coordination among service providers and a dominant charity orientation. The services have generally focused on start-up firms without paying due attention to supporting the growth of existing SMEs and providing them with the services needed to compete both locally and internationally.[76]

Various players have been involved in providing SMEs with business development services in Egypt. For instance, the mandate of the Small Enterprise Development Organization at SFD is to provide micro and small enterprises with technical assistance related to BDS. This is in addition to the role of the Industrial Modernization Center (IMC) that is in charge of the implementation of the Industrial Modernization Program in Egypt, and that aims at delivering

[74] ERF (2005).

[75] MOF (2004).

[76] According to the MOF (2004), the record of BDS provision in Egypt shows significant room for improvement. Non-financial BDS include information processing services, R&D and technical services, human resource development, marketing services, information dissemination on markets, standards and technologies, standardization and certification. See MOF (2004).

non-financial services through a number of Business Resource Centers (BRCs) established in a number of key industrial centers.[77] Table 3.9 provides a mapping of the geographical location of the main providers of BDS in Egypt.

Table 3.9: Location of Main Providers of Business Development Services in Egypt

	Location	OSS – SFD	Incubators[78]	BRCs – SFD	BRCs – IMC	Total
1	Cairo		2		1	3
2	Alexandria	1			1	2
3	Minya	1				1
4	Beni Suef			1	1	2
5	Damietta			1	1	2
6	Assiut	1	1	1	1	4
7	Qalubia		1			1
8	Dakahlia	1	2			3
9	Giza	2		1	1	4
10	Fayoum	1		1		2
11	Gharbia	1		1	1	3
12	Sharkia	1				1
13	Ismailia	1				1
14	Menoufia				1	1

Source: El-Nakeeb 2007.

In field investigations conducted by the Ministry of Finance and other entities, SMEs have expressed their need for better quality services. Marketing consultancy services for both domestic and international markets were their top priority.[79] The vast majority of these enterprises did not even attempt to export due to a number of reasons. These include inaccessibility of export channels such as specialized agencies that could guide SMEs as to where, when and how to market their products. Another reason was the lack of information about product specifications and standards that they need to abide by in order to market their goods abroad. Some entrepreneurs expressed that they cannot produce on a larger scale for export due to lack of financial resources.[80]

It should be noted that weak linkages between SMEs and their larger counterparts may have created a major impediment to increasing industrial exports and to improving the competitiveness of the sector.[81]

SMEs could play an important role in feeding larger firms with inputs, semi-finished parts, or providing them with channels of distribution or maintenance services. Evidence has shown that inter-firm linkages between large and smaller enterprises have been minimal in Egypt.[82]

It can be stated that there is room for improvement in the provision of BDS in Egypt as these are still at an early stage of development. A recent assessment of the success of BDS in reaching out to targeted clients in Egypt shows that most of the interviewed entrepreneurs have not used any of the services offered. The findings also indicate that none of the entrepreneurs have heard about services facilitating the registration, licensing and issuance of tax cards for small and micro firms that are offered by the One Stop Shop of the SFD. Similarly, none of the entrepreneurs had an idea about the BRCs established as part of the Industrial Modernization Program.[83]

The provision and use of BDS could be improved through the development of clusters that worldwide have drawn firms eager to take advantage of knowledge spillovers, specialized skills and suppliers as well as institutions and innovative technologies. Egypt has several clusters that have been provided some support by the government, such as the Damietta and Sha'a El-Te'aban clusters specializing in manufacturing furniture and marble respectively. The IMC has also provided support to handicraft clusters producing handmade carpets, woodworks, handmade textiles, alabaster, stones and ceramics all over Egypt.[84] There are more than 102 industrial estates at various stages of development. Most of these, however, lack the provision of common facilities such as product-testing laboratories, while some suffer the absence of adequate infrastructure such as gas or electricity.[85]

77 See El-Nakeeb (2007).

78 The SFD established a network of incubators across the country to foster the growth of start-ups and to improve their chances to compete in the global market. The selection criteria are based on a number of elements including the availability of adequate infrastructure services and the presence of an active business community, as well as proximity to universities and scientific research centers.

79 The difficulty of marketing has also been mentioned by entrepreneurs interviewed in focus groups conducted by El-Nakeeb (2007).

80 Benchmarking of firms along national, regional or sectoral lines has been used in developed countries such as the United Kingdom as one of the bases upon which consulting services are offered to firms to improve their performance. See MOF (2004).

81 According to a recent report by the Industry and Energy Committee of the People's Assembly, the industrial sector exports only 6 percent of its production with the share of SMEs not exceeding 0.5 percent. This is negligible compared to other developing economies such as India where 50 percent of its exports are manufactured by SMEs. See MOF (2004).

82 Based on the CAPMAS Industrial Census for 1998, it is estimated that only 2 percent of private industrial production is done in cooperation with other firms. Based on field investigations by MOF and others, SMEs noted that establishing linkages with their larger counterparts was not feasible due to a number of factors. These include inaccessibility as a result of being situated away from Cairo and the surrounding industrial cities, and lack of information on how to reach larger firms. This is in addition to their perception that large firms are vertically integrated and do not need any of their inputs. This results in an increase in the import content of domestic products, inflexibility and slow response to changes in market needs as well as lack of efficiency due to the absence of competitive pressures from SMEs. See MOF (2004).

83 El-Nakeeb (2007) conducted interviews with four focus groups made up of 16 male and 16 female entrepreneurs in Manshiet Nasser and Oseim. All interviewed entrepreneurs have been operating informally without any license, commercial registration, tax card or bookkeeping.

84 See El-Nakeeb (2007).

85 A cluster is defined as an agglomeration of firms in a related line of business. It can be made up of firms of different size. Examples run the gamut from Silicon Valley in the United States for software and computer industries to London for banking and financial services to Paris for fashion. See MOF (2004).

3.5 CONCLUSION

In order to better position itself in the domestic or global market, the SME sector has to seek out state-of-the-art means toward competitiveness, as traditional modes of production have been losing their significance rapidly.[86] The main pillars for creating a more competitive SME sector are comprised of R&D and innovation, technological development, product and quality improvement, and a high- and multi-skilled human resource base with the needed technical and technological capacities.[87] These elements should be supported by an enabling institutional framework with a well functioning financial system, an efficient regulatory environment and a vibrant educational infrastructure.

The general framework for enhancing the competitiveness of the SME sector, developed by the Ministry of Finance (2004), is consistent with the Government's current policy orientation which aims at promoting investment and creating more employment opportunities by stimulating the role of the private sector in the economy. Similarly, the twenty-year Industrial Development Strategy for Egypt over the 2005–2025 period that was recently developed by the Ministry of Trade and Industry aims at improving the competitiveness of the industrial sector, and that of the economy as a whole.[88]

The implementation of the industrial strategy is envisioned to be achieved over three phases in the short, medium and long run. While the short run phase aims at increasing both exports and employment, the second phase targets high quality industrialization by enhancing efficiency and productivity in the medium term. In the long run, focus is on improving innovative capacity in the economy to shift from reliance on low-tech production and labor-intensive industries to high-tech production and exports.[89]

The development of a coherent vision is of utmost importance to ensure smooth and consistent implementation of the strategies adopted by key concerned entities. In that regard, it is important to recognize a market failure associated with the current institutional gap that limits the benefits of the ongoing reforms that target a higher level of competitiveness for the economy as a whole. This gap has to be urgently addressed as there may be a need for a high level body, which could be at the Prime Ministerial level, to strategize and to coordinate policies of existing institutions based on a shared vision for growth. These institutions include but are not limited to the SFD, the IMC and GAFI. The focus of each entity could be sharpened by identifying a specific group of entrepreneurs for each to target. It may be suggested that the SFD focuses on micro enterprises, while the IMC caters to the needs of small and medium entrepreneurs, and GAFI deals with larger investors, maintaining its key role as FDI facilitator and promoter of investment.[90]

[86] Traditional modes of production rely on using unskilled workers, natural resources and simple technologies. Experience has shown that SMEs that rely on cost competition have been forced to reduce their profits, wages and standards to maintain their competitive advantage. In contrast, others have succeeded in maintaining their competitiveness by achieving technological leadership in their field, hence making larger profits by getting higher prices for their products. See MOF (2004).

[87] See MOF (2004).

[88] See Ministry of Trade and Industry (2006).

[89] See Ministry of Trade and Industry (2006).

[90] Country experience is instrumental in that respect. Forfás, Ireland's national policy and advisory board for enterprise, trade, science, technology and innovation that was established in 1994, has played a key role in promoting competitiveness and transforming Irish industry by ensuring coordination of policies adopted by Enterprise Ireland, Industrial Development Agency Ireland (IDA) and Science Foundation Ireland (SFI). While IDA has been mandated to secure overseas investment and to deepen existing FDI businesses in Ireland, Enterprise Ireland has been responsible for promoting the sales, exports and employment at domestically owned firms, establishing capacities for technological innovation and ensuring cooperation between industry and higher educational institutions. R&D has been the primary role of SFI, generating new knowledge, leading edge technologies and advancing cooperation between education, government and industry. See the Forfás website at http://www.forfas.ie/

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4. Speeding Up Regulatory Reform in Egypt Through the Regulatory Guillotine

Author: Scott Jacobs[1]

Egypt shares with many other developing countries the challenge of expanding "enabling environment" reforms that stimulate pro-growth business behavior. Around the world, governments are basing ambitious economic development and poverty reduction strategies on commitments that they will speed up and broaden policy and legal reforms to improve the business environment for investment.

"Enabling environment" reforms have become the norm in developing countries seeking to transit to a higher sustainable growth rate. The enormous policy, legal, and other regulatory inefficiencies that reduce productivity and hold back growth must be addressed mostly through regulatory reform. The pace and scope of regulatory reform has become an important determinant of the competitiveness of a country in international markets.

Regulatory reform is a very broad agenda. It includes reforms to the massive "stock" of regulations existing today and also improvement of capacities for developing and implementing future regulations. Regulatory reform can extend even further, into the institutions of the rule of law and the relationship between the state, market, and society through new methods of consultation with stakeholders such as the private sector. The problem is vast, and sustainable change requires not only reforms to thousands of rules, but also new institutional capacities and a shift by the public administration from a culture of control and rent-seeking to a culture of results-orientation and client services.

Regulatory reforms improve private sector performance in two ways: by freeing up the market and stimulating competition so that enterprises can adapt and innovate more quickly, and by enhancing the capacity of the public sector to provide an enabling environment of sound regulation and efficient public services.

Changes to a country's legal system to support new economic and social needs usually occur very slowly. Broad-based legal reforms are difficult to carry out and sustain over the whole of the public administration and across several years. The problems of successful reform are familiar. Reforms are resisted by interests in the public and private sectors who profit from corruption and protection. Fears of the consequences of change, low skill levels, anti-market sentiments, and the complexity and uncertainty of reform also slow down change. These factors must be dealt with effectively if reform is to succeed.

[1] Managing Director, Jacobs and Associates (www.regulatoryreform.com). This Chapter is entirely the responsibility of the author.

BOX 4.1: What Is Regulatory Reform and What Are Its Goals?

The regulatory system of Egypt is the full range of legal instruments used throughout the country, from national laws down to local licenses. It includes the procedures used to make new regulations, and the institutions (the regulators and inspectors) who write and implement rules.

Regulatory reform involves changes to these instruments, institutions and procedures to reduce regulatory costs, barriers to entry, risks and uncertainties, and associated costs of corruption.

Its goal is to produce a low-cost, low-risk regulatory system that is more effective in protecting public interests such as environmental quality, consumer safety and health, equitable growth, and many other public policies. Complex, outdated, and inefficient regulatory systems produce the worst of both worlds: high costs and risks that hurt the economy, and low government effectiveness in protecting the public.

4.1 THE CHALLENGE OF REGULATORY REFORM IN EGYPT

Finding ways to speed up change is an urgent matter. The cost of slow regulatory reform to Egypt in terms of lost growth and market opportunities is very high. The poor in particular pay a terrible price for slow reform. The challenge is to find ways to shift the complex system of laws, other regulations, and procedures in Egypt to support the rapid economic growth needed to produce the ambitious poverty reduction that is promised.

Like governments in most countries, the government of Egypt has committed to ambitious economic growth plans that can be achieved only with big and rapid boosts to private sector performance. This was reflected in the presidential Election Program of September 2005, which anticipates that:

- 4.5 million "new sustainable jobs" will be created over six years with a comprehensive package of programs, entitled "Our Youth Will Work," designed to provide job and career development opportunities to Egypt's youth.
- The investment climate will be enhanced to help generate these jobs.
- Financing of LE 3 billion will be provided to small businesses to create 100,000 new jobs.
- Financing of LE 60 billion will be provided to small and medium enterprises to create 900,000 new jobs.
- Financial support will be offered for 2,000 medium enterprises to provide an additional 150, 000 jobs.
- An Industrial Strategy will aim at establishing 1,000 factories to employ 1.5 million people.
- Desert land will be reclaimed, creating 400 new villages and thus providing 420,000 job opportunities.
- The tourism sector will be promoted, attracting investments of L.E 48 billion from domestic and foreign investors and drawing 14 million tourists by 2011.

To achieve these goals, the private sector in Egypt must invest more, innovate more, and expand faster. Stimulating these kinds of changes across hundreds of thousands of businesses in the economy requires very substantial changes to the commercial incentives facing businesses. Investors and entrepreneurs must take more risk, innovate more, and expand production and productivity. How will Egypt bring the private sector up to this new level of performance?

Regulatory reform provides one possible solution. But reform must be faster because Egypt is losing opportunities with every month that passes without reform. And reform must be broader because regulatory problems in Egypt stretch across the whole of the public administration — across 32 ministries, hundreds of agencies, across governorates and local authorities. The actions of all of these bodies combine into a regulatory jungle through which every business must find a path to survive. To address the problem, regulatory reform must take the perspective of the business and view the mass of regulations in its entirety.

Chapter 1 shows that the business environment in Egypt is not sufficiently competitive compared to its peers in the region. Indeed, it shows that the business environment in Egypt is worsening relative to peer countries. Far from expanding its markets, Egypt is struggling to maintain even the markets that it currently has.

There is no lack of reform in Egypt. Regulatory and administrative reforms are contained in many reform plans:

- Tax and customs reform by the Minister of Finance
- Industrial strategy by the Minister of Trade and Industry
- Investment Climate and FDI attraction strategy by the Minister of Investment and GAFI
- Reform of the financial regulatory system by the Minister of Investment (non-banking financial sector) and by the Central Bank (banking sector)
- Modernization of the real estate regulatory system by the Minister of Housing
- Reform of the public service by the Minister of Administrative Development
- Decentralization by the Minister of Local Development
- Single Window/One Stop Shop initiatives led by different agencies

These reforms recognize that businesses continue to struggle in Egypt due to the sheer weight of regulations. They are all useful reforms, but they are fragmented across many policy areas, and do not offer the broad and rapid changes needed to substantially improve Egypt's competitiveness standing and economic performance.

4.2 SPEEDING UP REGULATORY REFORM WITH THE REGULATORY GUILLOTINE

Some governments have speeded up reform in order to reduce regulatory barriers to growth, and have reaped the fruits of success. Mexico and Korea, for example, succeeded in managing rapid and broad regulatory reform programs, and as a result enjoyed substantial multi-year gains in economic growth.

BOX 4.2: What Donors Are Saying About the Regulatory Guillotine

"Although the results vary depending on how the reform is implemented, the evidence compiled to date suggests that guillotining can be an effective means of reducing needless bureaucracy and achieving a more carefully considered regulatory system." ***Best Practice Guide for a Positive Business and Investment Climate. Organization for Security and Co-operation in Europe (OSCE), 2006***

"The application of the Guillotine Law is one of the most significant events in the reform process since Moldova's departure from the USSR." ***USAID Frontlines, February 2006***

USAID BIH Director Howard Sumka **stated that the "guillotine of regulations" will cut through unnecessary measures that prevent investments in BIH.**

"The reduction by regulatory guillotine of business licenses in Kenya from 1,347 to 195 is a key result that will contribute to reducing the cost of regulation of the private sector in Kenya, and toward improving transparency and fighting corruption." Demba Ba, Head, Africa Region's Private Sector Development Group in the World Bank (June 2006)

Reformers in both countries faced similar challenges: conceptualizing, organizing, marketing, sustaining and implementing major programs of regulatory reform in the face of institutional weaknesses, incentive problems, and resistance from public and private sector interests. These heavily regulated countries managed to attack the regulatory problem across a broad front:

- South Korea succeeded in eliminating 50 percent of its regulations in less than a year through a national program of reform. This was part of an ambitious program of regulatory, financial, and structural reform aimed at boosting the competitiveness of the economy and recreating the foundations for sustainable growth.

- Mexico reversed 70 years of economic controls by revising over 90 percent of its national legislation in five years to open up and transform its economy. Over half of its licenses and other business formalities were eliminated and all the rest were simplified.

More recently, Kenya reviewed 1,500 business licenses and decided to eliminate over 700 of them, and to simplify many others.

The innovative reform strategy that was used by these countries was called the Regulatory Guillotine.™[2] The regulatory guillotine is not new. It has been used with several variations for the past 20 years since it was first pioneered in 1984 by the Swedish government, which was facing regulatory confusion caused by a century of accumulated rules. Results of the guillotine in the countries that have implemented it since 1995 suggest that the guillotine process:

- Produces rapid results (less than a year) in reducing the number of regulations and regulatory costs on businesses.
- Can be adapted to work in countries with high levels of capture and resistance in the public sector.
- Improves understanding and management of the regulatory problem by mapping out the full scale of regulatory interventions.
- Increases reform capacities by reducing the political and administrative costs of reform and eroding the capacities of insiders to block change.
- Creates the processes and organizational conditions for continued reform of the regulatory role of the public sector.
- Stimulates the development of active private partners for reform that will be useful in sustaining momentum.

Table 4.1 summarizes the results of the guillotine in five countries. The guillotine is normally launched and completed in several weeks to a year, although Mexico, which proceeded ministry by ministry, took five years to complete the reform. Each of these countries achieved substantial results — from 40 to almost 70 percent reduction in regulations and business fees, and simplification of many of the regulations left on the books.

Table 4.1: Results of the Guillotine in Five Countries

	Target of Reform	Number of regulations before cleanup	% of regulations eliminated	% of regulations simplified
Korea (11 months)	Regulations	11,125	48.80%	21.70%
Mexico (5 years)	Formalities	2,038	54.10%	51.20%
Moldova (16 weeks)	Regulations	1,130	44.50%	12.50%
	Fee-based Permits	400	68.00%	20.30%
Ukraine (12 weeks)	Regulations	15,000	46.70%	43.30%
Croatia (9 months)	Formalities	1,500	40% (target)	??

These kinds of substantial reductions in regulatory costs can have large and positive effects on economic activity by stimulating new investment and entrepreneurship. Table 4.2 shows how the reduced regulatory costs and lower barriers to entry were estimated to affect private sector activity and public sector costs in Korea.

Table 4.2: Direct Net Benefits of the 1998 Guillotine in Korea

Area	Net Benefit
Creation of jobs	1,066,200 jobs
Reduction of government costs	590 billion won
Increased Foreign Direct Investment	Increase of US$ 36.5 billion expected over 5 years

Note: These are projected direct costs and benefits arising between 1999 and 2003.

Source: Ha et al. 1999. p. 22.

But, despite these impressive results, if the guillotine stopped there, it would be a failed reform, because the ministries and other regulators would quickly replace the regulations that were eliminated. The most important benefit lies in how the guillotine prepares governments to move forward to a more sustainable strategy of reform. Here, the guillotine seems to perform well. In all countries, the guillotine is being followed by second-phase reforms that are aimed at institutionalizing regulatory quality controls for new laws and regulations through strategies such as central units for regulatory reform, creating systematic consultation procedures, and building capacities for regulatory impact analysis. This is persuasive evidence of the sustainability of this kind of strategy even in countries with poor records of sustaining difficult, medium-term reforms.

[2] The term "Regulatory Guillotine" is a trademark of Jacobs and Associates Inc.

The guillotine illustrates that momentum and institutionalization are key to successful reform. The reform program should be based on an accelerating, expanding strategy that engages a wider and wider group of interests. Government reforms that are credible and produce results change the political economy inside the country, releasing reform energies, and reinforcing a growing consensus about market reform. As reforms stimulate changes, they help governments overcome governance bottlenecks, such as the ability of insider groups to stop further reforms that are contrary to their interests.

4.3 WHAT IS THE GUILLOTINE APPROACH?

The regulatory guillotine is intended for situations where governments are moving rapidly through the transition process from state-led growth to market-led growth. In essence, it is a means of rapidly reviewing a large number of regulations, and eliminating those that are no longer needed without the need for lengthy and costly legal action on each regulation. Like its namesake, it is clear, decisive, and fast.

It is expressly designed to:

- Reverse incentives in the reform process, and so overcome the barriers that have slowed or blocked broad-based regulatory reforms in the past. These barriers include high political and administrative costs, intense and passive insider resistance to change, and lack of planning on how to sustain change into the future. The guillotine is designed to reduce the costs of reform within a political and legislative system that is already overburdened with difficult reforms.
- Create a sustainable process for future quality control and legal security, mainly by establishing a quality checklist and review process and creating a comprehensive and central regulatory registry with positive security.

The guillotine is an orderly and transparent process of counting the regulations that exist, and then reviewing them against clear criteria. The basics of the guillotine work like this:

1. The government establishes the scope of the guillotine, that is, defines precisely the kinds of regulatory instruments to be included and the regulatory bodies. This can be the entire government, as in Korea, or selected ministries.
2. The government adopts a legal instrument — usually a law or decree — that sets out the guillotine process, schedule, and institutions.
3. The government creates a central guillotine unit at the center of government (reporting to the government or the prime minister or president) that manages the reform and carries out independent reviews.
4. In the guillotine process, each regulation must be justified as meeting basic criteria. That is, the burden of proof is on the regulator to defend why the regulation should be kept. Three typical criteria are:
   - Is the regulation legal (has it been published and is it authorized by parliamentary law)?
   - Is the regulation necessary for future policy needs?
   - Is the regulation business-friendly?
5. If justification can't be provided to show that a regulation is needed and legal, it is identified for elimination. If a regulation is justified but not business-friendly, it should be simplified. The regulation passes through three subsequent reviews. In each review, unnecessary, outdated, and illegal rules are identified.
   - In the first review, all government agencies establish a complete inventory of their regulations within the scope of the guillotine and justify each one according to the criteria. Each regulation is designated as one for elimination, simplification, or retention.
   - The second review is conducted by the central review unit, which examines those regulations that passed the first review and creates its own lists of regulations to be eliminated, simplified, and maintained. The central review unit often disagrees with ministries about what regulations are justified.
   - In the third review, the lists are reviewed by stakeholders such as business associations, and recommendations are given to the central review unit.
6. Once the final lists are completed by the central review unit, the entire package is sent to the government or to parliament for adoption as a single package. When the package is adopted, all regulations on the "eliminate" list are cancelled, immediately or in the near future.

7. Everything that is maintained is placed into a comprehensive electronic registry that is recognized in law as the legal database of regulations for purposes of compliance.
8. In the future, all new regulations and changes are entered in the registry within one day of adoption and/or publication. The registry should have legal security, i.e. no regulation not in the registry can be enforced against a business.

One aspect of the guillotine that is critical, but unfamiliar to many governments, is its transparency and public character. This reform is not a reform carried out in closed conference rooms, away from the view of the public. To the contrary, the governments who have carried out successful guillotines have launched public media campaigns, accompanied by national hotlines and websites, to market the reform to the entire country. In Croatia, a national hotline has generated many hundreds of suggestions for simplification, and many others have written their suggestions on the web site that has been established. In Moldova, an education/communication/branding campaign was launched, resulting in increasing public expectations and reducing the risk of backtracking by the line ministries. With this kind of visibility, the guillotine becomes a highly public political commitment, and this part of its sustainability against resistance.

4.4 COULD A GUILLOTINE BE CARRIED OUT IN EGYPT?

Egypt could gain very large benefits from a reform such as the guillotine. Tens of thousands of regulations exist inside the ministries and regulatory bodies, and most have never been systematically counted or assessed since they were adopted. Many are apparently outdated, duplicative, inconsistent or otherwise unneeded. Simplification of this complex and high-cost regulatory environment will have direct benefits for everyone: businesses, consumers, and even government institutions will be able to move more freely and with lower burdens of corruption, pay lower prices, and focus on the important issues of governance.

The Egyptian government has already created the essential conditions for launching a guillotine: political commitment to broad and rapid reforms and a systematic effort to reform the civil service with its 5.7 million employees. Commitment from a core group of ministerial-level reformers with the authority to act is essential to this kind of bold reform. Both the plans of the government and the reforms of individual ministers create an environment in which ambitious reforms such as the guillotine could be adopted and implemented.

One of the most important decisions to be made in the regulatory guillotine is the scope of the reform across three dimensions: institutions, legal instruments, and a reference group. The proposal here is to operate the guillotine 1) across eleven ministries that make up the Production Committee of the Cabinet; 2) at the level of subordinate legal instruments (not including laws); and 3) for all regulations affecting business start-up and operation.

4.4.1 Institutions

The guillotine is designed to be operated across the entire public administration. Such scope will produce the best results, but it is heavily conditioned by political constraints. After discussions in Egypt, the most feasible scope seems to be, not across all the 32 ministries at once, but across those ministries most ready to move forward. It is recommended that a start should be made with the group of ministries that make up the Production Committee with the possibility of others joining in later. These Ministries are:

1. Trade and Industry
2. Investment
3. Finance
4. Housing
5. Agriculture
6. Administrative Development
7. Health
8. Labor
9. Transport
10. Military Production
11. Civil Aviation
12. State for Local Development

4.4.2 Legal Instruments

The guillotine can operate at any level of regulation: parliamentary law, government decrees (prime ministerial and ministerial decrees), or governorate decrees and formalities. Or it can focus on regulations with specific characteristics, such as licenses (as was done in Kenya) or such as business formalities and procedures (as was done in Mexico and Croatia), or on all regulations with business effects (as was done in Korea). Of course, adoption of the final set of recommendations must be done by the body responsible for that level of regulation, i.e., the parliament must adopt changes to laws, while the government can adopt changes to lower level regulations.

A crucial issue is that the regulations in Egypt have never been inventoried, and their exact number is unknown. Some have estimated that around 30,000 subordinate regulations might exist within the target 10 ministries, but this estimate might be too high or too low. Producing a comprehensive map of what regulations actually exist, by category, will be a major output of this reform.

It is proposed here to design the guillotine process in Egypt so that it counts all regulations but reviews only a subset of them:

- First, the inventory of regulations should be comprehensive, listing all laws and all other subordinate regulations down to the lowest possible level (instructions) for which each ministry is responsible. The complete inventory and classification of regulations will assist all future reform efforts, and will serve to make more transparent the regulatory regimes of Egypt. Four months is given in the schedule to complete this large task of inventorying and classifying regulations.
- Second, the review process of the guillotine should focus only on those regulations that are subordinate to law and that affect businesses. This means that action the parliament is not needed to implement the guillotine, and should speed up results. However, this limits the scope of the guillotine since laws tend to be a key part of the regulatory problem. To help address this, this initial guillotine can help identify problematic laws, and a guillotine of laws themselves can be done in a second stage.

4.4.3 Reference Group

Both businesses and citizens face major regulatory costs in Egypt, but this reform is part of the national competitiveness strategy and hence the first priority is to focus on impacts on businesses. It is proposed here that the guillotine, although it will inventory all regulations, focus only on those regulations that affect business start-up and operations. This will reduce the scope of the first guillotine to a more manageable level, while still producing significant results.

4.5 THE EIGHT STRATEGIES OF THE GUILLOTINE IN EGYPT

The guillotine process rests on a series of strategic and operational decisions that are categorized into eight concrete strategies. Assumptions about these eight strategies in Egypt are summarized below.

1. Political strategy to create and sustain a supportive political coalition

The guillotine requires top-level, visible and sustained political commitment. In Egypt, this seems likely to require support from the Government through the Ministerial Group on the Production Committee (MGPC), the PM, and the ruling party. Key ministers should support the guillotine, most visibly by participating in the first group of ministries to be reviewed, and the guillotine process itself should be recommended by the MGPC (or the full Government), and then mandated by a PM decree or higher level instrument. The guillotine unit itself should be responsible for results either to the Government or to the prime minister. The PR machinery of the Government should be responsible for the major public and media communications strategy.

2. Administrative strategy to establish the review and the central review group, and carry out the day-to-day review process

The administrative strategy is the core operation of the guillotine. It encompasses the entire step-by-step process of review of each regulation, which is planned in detail in advance and implemented using project management software. It is managed by the guillotine unit, which should be independent of the ministries and responsible directly to the government or the prime minister.

The guillotine should be headed by a leader who is appointed full-time for about 14 months, and staffed as suggested below. The staff can either be seconded from reform-minded institutions or hired directly. The legal and analytical work of the guillotine unit is not very complex, and even graduate students in law and economics can perform well.

Table 4.3: Possible Staffing of the Egyptian Guillotine Unit

Staff categories	Estimated Months
Head	14
4 subdirectors (4 persons at 11 months each)	44
Support staff (1 fulltime person at 12 months and 2 at 11 months each)	34
IT operation and database management (3 persons at 11 months each)	33
Expert staff (151 persons for 9 months, based on 1,364 months to review 30,000 regulations at 8 hours each)	1,364

3. Legal strategy to create the legal conditions for success, write a formal legal mandate, and develop the legal means of implementation

The guillotine must operate smoothly based on a clear legal strategy that ensures that the guillotine can be implemented using existing legal procedures and that it creates legal security and transparency rather than legal chaos. The legal strategy depends partly on the scope of the guillotine, that is, the level of instruments involved in the institutions needed to implement recommendations. The legal strategy for Egypt is not yet developed, and will depend on final decisions on the scope.

4. IT strategy to ensure that the management software and website work well and the eRegistry is well-designed and credible

Pieces of the guillotine process will rely on well functioning IT inputs:

- The project management software
- The central website
- The eRegistry

As far as possible, pieces of these inputs will be brought from other guillotine operations. The Croatian guillotine was particularly well designed and was the only one to use a specially tailored software to structure and order the entire guillotine process from start to finish. The Egyptian guillotine should attempt to procure the software and tailor it to the local environment.

5. Analytical strategy to measure the cost-savings of reform

The question is always asked at the end of the guillotine: what cost-savings resulted? Jacobs and Associates has adapted the Standard Cost Model used in Europe to estimate quantitatively the guillotine results. This approach will need to be adapted for application to the Egyptian guillotine.

6. Communications and consultation strategy to inform the public and to enlist the participation of key stakeholders

The guillotine process is meant to be highly visible and communicated to the public through a proactive media campaign. This part of the process should be handled in Egypt by the PR machinery of the government or the prime minister's office.

7. Monitoring and implementation strategy to be sure the guillotine actually has effect on the ground due to changed behavior by inspectors

Changing the text of regulations is not a complete reform in Egypt. In one instance, a regulation was abolished 22 years ago, but it is still being enforced. Some kind of monitoring and implementation strategy is needed following the legal reforms of the guillotine itself to ensure that legal changes are translated into real action at the level of enforcement and inspection. GAFI seems well placed to develop such a strategy of post-guillotine monitoring, based in part on government action in part on empowering the private sector itself to monitor and report on developments. A credible mechanism for correcting problems will be needed, and here the GAFI mediation process might offer a solution. More discussion is needed to develop this strategy.

8. Preparation of sustainable regulatory reform strategy for phase 2 and drafting legislation for submission to parliament

The guillotine is a failed reform if reform stops once it is finished. Egypt should use the guillotine to begin a continuous process of converging with international good regulatory practices. The elements of the guillotine — the quality control process, the central unit, the public consultation, electronic registry — should be institutionalized and maintained for all future regulations. Planning for institutionalization should begin early in the guillotine process, and drafts should be submitted through the political process, so that this reform is in place and ready to move forward at the conclusion of the guillotine.

4.6 CONCLUSION

The regulatory guillotine is not the only tool that Egypt can use to accelerate regulatory reform and to break the logjam that has held back regulatory reforms. There will always be a need for focused reforms that target specific rules and procedures that are particularly onerous or complex. But the guillotine is an illustration of the kinds of intelligent reforms that are needed to move beyond the narrow and one-off reforms that are so common in the field today, to produce big results that are consistent with the ambitious development goals of growth and poverty reduction that the government has adopted.

5.

CONCLUSION: FROM PIECEMEAL TO COMPREHENSIVE REFORM

Despite serious but piecemeal reforms, Egypt's competitiveness is declining both globally and when measured relative to other Arab countries. *It is slipping relative to other countries on the Global Competitiveness Index and the Business Competitiveness Index. Despite its historic and cultural assets, Egypt does not rank that highly in the Travel and Tourism Competitiveness Index. More troublingly, Egypt ranks near the bottom of all countries in the World Bank Doing Business Indicators. This latter report has been of grave concern to those who work hard to see more business done in Egypt.*

Even with recent growth, the Egyptian economy is faced with daunting challenges. Despite strong growth in GDP, exports, reserves and foreign investment, the environment for small and medium business and for the long-term competitiveness of Egyptian industry in general is not strong. Official unemployment is still unacceptably high, near 10 percent, and this figure masks significant underemployment. Some 54 percent of the urban labor force is still employed in the low productivity, low income informal sector. Macroeconomic imbalances that include high fiscal deficits, high public debt and rising inflation are troubling.

Piecemeal reforms are not enough. There is no alternative to comprehensive reform effort. Piecemeal action will not solve the problem. The speed of reform must increase. The scope of reform has to be across all relevant ministries. And efforts need to be synchronized for all sectors, and among all actors.

The fourth ECR proposes that private and public leaders formulate a national competitiveness strategy. There is an urgent need to formulate a comprehensive competitiveness strategy with specific practical initiatives that together support this strategy. The design, implementation and monitoring of a full-strength competitiveness strategy will require the support of the government, the private sector, labor and educational leaders and the media. This Private Public Partnership has to be implemented comprehensively and made a priority.

It is imperative that a broad-front campaign should transcend the territorial boundaries of line ministries in favor of a coherent vision with specific and time-bound objectives as well as defined instruments and institutions. Partial reforms risk reversal. The creation of isolated islands of reform in an environment that favors and defends the status quo is no solution. For example, Egypt will not be able to achieve the ambitious objective of transforming the Egyptian economy into a leading industrialized nation in the MENA region, as proposed in the National Industrial Development Strategy, if the pace of change remains as it is. Egypt cannot become a world class export hub for manufactured products unless it has a world class workforce. Egypt cannot achieve global competitiveness if reforms are limited to a few ministries, even ministries as proactive as the Ministry of Finance, Ministry of Investment and the Ministry of Trade and Industry. Reforms must extend to the whole system. A modern and competitive workforce is absolutely essential. Domestic industry cannot be expected to thrive when it is not yet free from over-regulation and harassment. As in many Asian countries, the civil service can have a great role to play in encouraging a robust economy and removing the restrictions on future achievement.

The fourth ECR proposes a frontal attack on unnecessary and disruptive regulations through a "guillotine" approach. As presented in Chapter 4, the ECR proposes that all regulations be reviewed and those which are unnecessary, illegal or unhelpful to growth be either dropped or amended. The response from the domestic private sector will be surprising. Such efforts will also be rewarded politically by those who recognize and feel the change. This will require not just changes in laws and regulations but also changes in mindsets. The bureaucracy will be transformed into a modern, service-oriented civil service whose mission is to help create the conditions for a thriving economy and efficient government services. Unnecessary regulations must be eliminated. The "guillotine approach" proposed here is an instrument that has been tested and proven at the international level, with tangible results. In one year's time, the results could be surprisingly significant.

Human resources development and labor market reform will unite the national competitiveness strategy with pro-poor economic growth. A serious effort must be made to improve the quality of human resources from a demand-driven perspective. Survey after survey shows that students are disappointed in their education and that the private sector is disappointed with the lack of skills in those entering the labor market. The government has made great progress in primary level enrollment but must now focus on the issues of educational quality and relevancy. Policies on resource use, renewable energy and agriculture must be reviewed. Labor markets, product markets and financial markets need reform as does corporate governance and shareholder protection.

Finally, there needs to be an annual, honest monitoring and evaluation of the progress of the economy. *The Egyptian Competitiveness Report* will continue to hold up an honest mirror so that all can see the progress and performance of the country. It will provide an annual scorecard to measure change. This year the ECR is saying that despite economic growth, many underlying causes of Egypt's lack of competitiveness have gone untreated. Meanwhile, other countries advance at a faster pace. The good news is that Egypt can also make more rapid advances as other countries have done. However, Egyptian leaders must now respond to the challenge and take bold action.

The ENCC invites private, public, civic and academic leaders to a dialogue resulting in a national competitiveness strategy that would enjoy broad support and be inclusive. But there needs to be a comprehensive strategy drawn up, agreed upon and supported by a large segment of Egypt's leaders and the population at large. The creation of a *National Competitiveness Strategy for Egypt* must become a reality in the coming months. This strategy should have serious, practical and measurable steps by which progress can be verified. The legislative, executive and judicial branches of government must be involved in supporting implementation, as must the leadership from the private sector, academia, labor and civil society and the media. Only then can Egypt improve its competitiveness in both the indicators and reports that circulate globally and in the underlying reality verified by continued growth in GDP, productivity, exports and investment. If these recommendations are implemented, *Egypt's national competitiveness strategy* will also be a pro-poor economic growth strategy, the nation's safety valve, creating a politically and socially viable future characterized by a renewal of trust and a freeing up of untapped resources in the Egyptian soul to again make leading contributions in technology, productivity, effort, imagination and innovation. The ENCC will push for an inclusive growth regime that caters to the needs of the broad base of the population. Competitiveness means achieving higher productivity which the average citizen "can feel in his/her pocket."