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Egypt
Social and Structural Review

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Social and Economic Development Group
Middle East and North Africa Region

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Currency Equivalents

Currency Unit = Egyptian Pound (LE)

Exchange Rate Effective June 19, 2001
LE 1.00 = US$ 0.259
US$1.00 = LE 3.86

LE per US dollar
(Period Average)

1990	2.61
1991	3.01
1992	3.32
1993	3.33
1994	3.37
1995	3.39
1996	3.40
1997	3.39
1998	3.40
1999	3.40
2000	3.41

Fiscal Year

July 1 – June 30

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List of Abbreviations

BOP	Balance of payments
CAPMAS	Central Authority for Public Mobilization and Statistics
CBE	Central Bank of Egypt
CY	Calendar year
ESA	Employee shareholder association
ESSR	Egypt Social and Structural Review
EU	European Union
FDI	Foreign direct investment
FTA	Foreign trade agreement
FY	Fiscal year
GDP	Gross domestic product
GNP	Gross national product
GOE	Government of Egypt
GST	General sales tax
ICOR	Incremental capital to output ratio
IFC	International Finance Cooperation
IFPRI	International Food Policy Research Institute
IFS	International Financial Statistics
IMF	International Monetary Fund
INP	Institute of National Planning
IPO	Initial public offering
LMIC	Lower middle income countries
MENA	Middle East and North Africa
MFN	Most favored nation
MNC	Multi-national corporation
MOF	Ministry of Finance
MOHP	Ministry of Health and Population
MOP	Ministry of Planning
MOSA	Ministry of Social Affairs
NAFTA	North American Free Trade Agreement
NIB	National Investment Bank
PPP	Purchasing power parity
SME	Small and medium enterprise
TFP	Total factor productivity
UNDP	United Nations Development Programme
VAT	Value-added tax
WDI	World Development Indicators

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ANNEXES

Executive Summary

1. Egypt's growth performance in the 1990s has been robust yet questions arise to its future sustainability unless structural changes are introduced. Growth has been driven by domestic demand rather than through participation in world trade which has underpinned growth in the best performing countries globally. In order for Egypt to continue achieving high rates of growth, it will need to adopt policies that facilitate its further integration into the global economy. In preparation for the increased external competition that will result from the European Union Association Agreement, the business environment will need to be improved in order for the domestic economy to benefit from trade liberalization.

2. Have Egyptians benefited from the rapid growth? Labor market developments, especially employment and wages are key to understanding the impact of growth on the majority of the population. Higher real wages and more employment opportunities, especially for low-income groups, result in better living standards and less poverty. The quality of life is also heavily influenced by the Government, especially through its dispensation of resources. How well the public sector delivers services to the population, especially to lower income groups, will have a direct impact on peoples' living standards. The budget process plays a key role in determining whether resources are channeled effectively and efficiently.

Purpose of Report

3. Within the last few years, the World Bank has developed an analytical instrument for middle income countries called a "social and structural review". Its aim is to identify the strategic policy priorities that are likely to yield the highest returns in terms of poverty reduction and development. The *Egypt Social and Structural Review* (ESSR) identifies those priorities by providing a systematic evaluation of economic policy and structure in order to identify (a) the main constraints on poverty reduction and long run development in Egypt and (b) the sources of vulnerability, particularly as Egypt considers further global integration through entering into foreign trade agreements.

4. The report takes a broad approach and discusses a number of important issues but does not address other critical questions due to the lack of adequate information (such as the impact of growth on poverty, the financial sector, and the mega projects). The areas covered in the report are: macroeconomics and growth, employment and welfare, global integration, and the budget process. The ESSR is most relevant for senior government officials who are knowledgeable about economic trends in Egypt.

Priority Areas for Reform

5. The overarching objective of this report is to identify reforms to achieve high economic growth in the medium- and long-term, provide better employment opportunities especially for low-income groups, and improve delivery of public services to the population. The five priority areas for reform that the Government may want to consider addressing are as follows:

First, in order to maintain Egypt's robust economic performance of the late 1990s, the Government will need to continue to implement reforms. The appreciation of the real exchange rate combined with low productivity gains have eroded Egypt's international competitiveness making it more difficult to pursue an outward-oriented growth strategy. The most important step that needs to be taken is to maintain stability of the macroeconomic environment by strengthening economic management which may have been pushed off-course by exogenous shocks in the latter half of the 1990s.

Second, trade liberalization remains an unfinished and critical area for further reform. By sharply reducing tariffs and other trade taxes, especially on manufactures, Egypt can achieve productivity gains and wage growth. Reform in this area should be initiated first, since otherwise foreign direct investment attracted will be of the "tariff-jumping" nature and is unlikely to improve domestic competition or export performance. However, trade reform will need to go hand-in-hand with tax reform because of the implied loss of revenues.

Third, it is important to revisit government regulations that increase the cost of doing business in Egypt. Though the Government has taken many important and essential steps to improve the investment environment, Egyptian markets will be more competitive if the barriers to entry and exit from the market are further lowered. This will benefit Egyptian consumers, especially low-income groups who can ill afford to pay prices above international levels.

Fourth, expenditures of the bottom half of the population appear to be fairly compressed. In 1996 the bottom 60 percent of the population at most had expenditures per capita 30 percent above the poverty line. Thus, small shifts in income could have large implications for the population's welfare. Policies which improve workers' access to jobs in high productivity sector, such as manufacturing, are key to a poverty reduction strategy.

Fifth, the quality of life of the population is in part determined by public services such as those that enhance health, education, sanitation, clean water, and air quality. The first step to ensuring that the nation's resources are better spent in these areas is by taking steps to improve the results-orientation of the budget, especially the recurrent budget.

Summary of Chapters

6. This report is divided into six chapters. Following the introductory chapter, Chapter II is about macroeconomic developments and growth. It analyzes the sources of growth in Egypt and discusses under what circumstances growth is sustainable in the long-run. Chapter III identifies the challenges to Egypt's global integration and presents an analysis of the impediments, especially trade barriers, facing private sector development. Chapter IV presents the most recent information available on labor market developments, poverty, and public expenditures on the social sectors. Chapter V discusses the national budget process and how it could be changed to improve service delivery. The last chapter presents the priority areas for reform.

7. The remainder of the executive summary provides a brief overview of the main findings.

Chapter II: Macroeconomic Developments and Growth

8. ***Sources of growth.*** Egypt's economy grew by an average of 4.9 percent per annum during 1991-2000. Growth was driven by domestic rather than foreign demand, especially the

accumulation of labor and capital rather than productivity growth. Why does it matter that Egypt's growth was primarily a result of factor accumulation? The reason is that for Egypt to attain high growth rates in the future, additional financing for investment will be needed. Investment will need to increase to between 27-35 percent of GDP if Egypt wishes to reach the growth targets set in the Government's long-term strategy.

9. ***Factors behind higher investment.*** Not only did public investment increase in the latter part of the 1990s, but more importantly, private fixed investment increased as well. Public investment is determined by the Government and constrained by fiscal balance targets and debt management issues. Public investment rose rapidly in the latter part of the 1990s leading to higher public deficits which may indicate a relaxing GOE's fiscal targets. Economic conditions are more important in determining changes in private investment. Two main factors that appeared to have affected the increase in private investment in Egypt were (i) macroeconomic stability appears to be a key factor indicating that there was a substantial payoff to the economy from the Government's austerity measures and structural changes; and (ii) the decrease in the cost of investment funding may have played an important role in the rise in private activity.

10. ***Sectoral contribution of growth.*** What sectors contributed to Egypt's growth in the 1990s? With the exception of manufacturing, non-tradeable sectors (that is, services and construction) were largely responsible for the majority of growth. Agriculture made a modest but consistent contribution to GDP growth of about 0.5 percentage points per annum. In 2000, the construction boom with double digit growth rates appears to have collapsed and services' contribution slowed down significantly.

11. ***Exogenous sources of income.*** The far-reaching transformation underway in Egypt is the declining importance of income from exogenous sources in the economy. Suez canal tolls, oil export earnings, worker remittances, and tourism receipts accounted for 12 percent of GDP in 2000. Though this income has helped to finance public services and private consumption in Egypt, they may also have had two undesirable consequences. First, it could have reduced the pressure to implement the wide array of reforms needed that would enhance the competitiveness of manufactures. Second, the income from exogenous sources of the magnitude received by Egypt could have undermined the competitiveness of Egyptian producers in international markets, especially the profitability of the agricultural and non-resource based industrial sectors, by strengthening the national currency.

12. ***Balance of Payments.*** The balance of payments (BOP) has been under pressure since 1998 following the impact of exogenous shocks on oil and tourism revenues. Egypt has consistently lost international reserves during 1998-2000 such that the initial stock fell by 25 some percent, falling to US$ 15 billion in end fiscal year 2000. Notwithstanding this, Egypt does not appear to face a short-term risk of a BOP crisis since reserves continue to be adequate to cover imports for 8 months and external debt can be serviced, in particular, short-term debt is relatively low. But the pressures also reflect the vulnerability of the BOP to external shocks due to Egypt's heavy reliance on exogenous sources of income which combined constitute 28 percent of current receipts.

13. Overall, the policy response of the Government to the BOP pressures was muted and at times contradictory as it struggled to maintain at the same time the exchange rate peg and its growth objectives. The most inconsistent action was the adoption of an expansionary fiscal policy during this period. Monetary policy may have also increased the pressure on the exchange rate peg for much of this period. During 1998-1999, credit growth remained high, indeed, credit

grew faster during this period than prior to the BOP pressures. The growth in "quasi-money" increased significantly in 1999 by 11 percent.

14. Recently, in January 2001, the Central Bank of Egypt (CBE) declared a new exchange rate policy which nominally pegged the Egyptian pound to the US dollar at LE 3.85/US$ but introduced a band. The advantages of the new exchange rate policy is that it implies a built-in flexibility in the exchange rate regime. However, it carries the risk that a parallel market for foreign exchange may emerge in Egypt if the new system is not managed according to the supply and demand for foreign exchange. Early implementation of the new regime did not see changes in the central rate and at the same time foreign exchange dealers have been restricted to transact within a very narrow band from the central exchange rate.

15. There have been three consequences of the Government's policy package pursued since 1998: (i) a liquidity squeeze due to the tight monetary policy pursued in 2000 and the accumulation of payment arrears by the Government which were officially estimated at LE 16.8 billion in 2000 or 5 percent of GDP; (ii) increased dollarization which though well below the levels seen in the early part of the 1990s, the growth of foreign currency in the money base has been very rapid during the last two years; and (iii) a slow down in the non-oil economy of Egypt.

Chapter III: Opportunities for Global Integration

16. This chapter seeks to identify measures that the Government could take to facilitate the economy's integration into world markets. It is organized into three sections as follows: (i) Egypt's integration into the global economy both in terms of exports and FDI; (ii) internal barriers to exports; and (iii) regional integration issues.

17. ***Composition of Egypt's merchandise exports.*** Egypt's merchandise exports account for less than 3 percent of GDP in 1999. The country's natural resource endowment underpins 71 percent of the export basket. About two-thirds of merchandise exports are petroleum-related and agricultural materials indicating a fairly un-diversified basket. Though Egypt has begun to process more of its domestically available primary goods to the final stage, much of the increase has been in petroleum products. The larger concern is that share of unskilled and skilled labor-intensive products fell during the 1990s – which indicates that exports are less labor intensive than previously.

18. ***Impact of protection on exports.*** Why does Egypt not export more manufactured goods? An explanation can be found in Egypt's import policies which result in raising the cost of imported inputs to domestic producers above international levels. Thus, in order to be globally competitive, exporters instead use the few domestically available natural resources as inputs. This lack of access to internationally priced inputs may help explain why Egypt has not become part of the new division of labor where multi-national companies outsource production of parts to other companies globally. Consequently, Egypt's participation in the three large international production networks (information, furniture, and automotive) has been minimal. Thus, the protection afforded the manufacturing sector during the 1990s, did not lead to a significant supply response from the private sector as can be seen from limited growth in the share of the manufacturing sector in the economy.

19. ***Potential and type of foreign direct investment.*** Egypt has the possibility of being attractive to foreign investors because it is the largest potential market in the Middle East region and because of its proximity to European and Arab markets. Yet Egypt's potential to absorb FDI is significantly higher than actual inflows, although there has been considerable improvement

since 1997. One reason that Egypt may not be able to obtain the level of flows it could is that the administrative process of establishing a legal presence is complex, time consuming, and costly. However, once a foreign firm establishes itself, the regulatory environment appears to have few explicit biases against foreign firms compared to domestic firms. Foreign investment that has taken place in Egypt does not appear to have contributed to exports, rather it appears that FDI firms tend to produce for domestic markets and are benefiting from the protection afforded by high tariff barriers.

20. ***Main problems with Egypt's tariff and para-tariff structure.*** Egypt's tariffs are high by developing country standards: 28 percent compared to 18 percent for lower middle income countries. Additional taxes and charges add an additional 3 percent. The tariff structure is not uniform and discriminates against low processed products (which would be more in line with Egyptian producers' capabilities), leading to significant tariff escalation. Effective tariffs for fully processed products are significantly higher than tariffs for semi-processed products and raw materials which has the undesirable consequence of divert resources away from export to import-substituting sectors. The result of this protection has been to contribute to low competition in domestic markets and Egyptian consumers have to pay high prices for below-average quality goods.

21. ***Other factors impeding competition from imports.*** Although tariffs and para-tariff remain powerful instruments of protectionism in Egypt, other factors impede imports and thereby limit contestability of domestic markets. The primary obstacles faced when trying to bring imports into Egyptian territory are customs procedures, administrative controls, and quality controls. Not only do these procedures give undue protection to domestic producers, but they also hurt Egyptian exporters who use imported inputs.

22. ***What discourages business from thriving in Egypt?*** It is difficult for an outsider to navigate the country's business environment. This is one reason that Egypt ranks low in various surveys assessing "business-friendliness" of economic regimes. In order to increase domestic competition and new business formation, several areas particularly relevant to public-private interface should be evaluated for reform. These include (i) privatization, (ii) corporate taxation, (iii) the commercial legal system, and (iv) the financial system.

23. ***Bilateral trade agreements as a means of global integration.*** Bilateral liberalization has been the major trait of Egypt's foreign trade policy since the mid-1990s. However, significant benefits from regional liberalization are not likely to materialize unless accompanied by multilateral liberalization due to the reasons discussed earlier. These types of agreements can unintentionally complicate the trade regime of a country, especially if the various FTAs adopt different tariff structures and agreements on negative and positive lists for exports. Furthermore, ambiguities can arise with the trading relationship with other signatories of an FTA especially. Hence, it may be advisable to undertake a detailed review of all FTAs in order to search for ways to maximize Egypt's benefits from these agreements, especially in the context of the expected adoption of the Euro-Mediterranean Agreements. FTAs should be assessed from the point of view of the extent to which they represent a stepping stone to global integration of the Egyptian economy.

24. ***Improving access to QUAD markets.*** The best opportunities in the medium-term for Egypt's exports lie in the markets of Canada, European Union, Japan, and the United States known as the "Quad" markets. In spite of the tariff preferences granted by the Quad countries under different Generalized System of Preference regimes, Egyptian exports still face tariff peaks with rates above 15 percent for a significant number of both agricultural and manufactured prod-

ucts. Egypt seems to be competitive in a large number of "Quad-peak" tariff products. Egypt can negotiate better access for its products to Quad markets by linking these discussions to liberalizing access to Egyptian services markets. If Egypt had duty-free access in Quad-peak tariff items, the value of Egypt's exports would increase by around $350 million on an annual basis, and total exports would increase by 10 percent. The change in exports triggered by the elimination of "peak" tariffs would vary across Quad markets with the largest potential for growth in exports to Canada.

Chapter IV: Towards a More Results-Oriented Budget Process

25. The chapter presents suggestions towards making the budget process in Egypt more results-oriented or "performance based". The chapter (i) provides a general overview of the budgetary processes and suggestions for improvements; (ii) gives an overview of public expenditures and financing; (iii) discusses steps that could be taken to move from input-oriented management to results-oriented management in order to improve the impact of government expenditures on the population.

26. ***Overview of public expenditures.*** Total expenditures in Egypt are 27 percent of GDP, compared to 16 percent of GDP for lower middle income countries. The recurrent and capital expenditures are 20.2 percent and 6.8 percent of GDP respectively. The trend exhibited in public expenditures as a share of GDP in the latter half of the 1990s is that recurrent expenditures are contracting gradually while public investment appears to be on the upswing. The GOE was successful in reducing recurrent expenditures, yet its beneficial effect on the overall deficit was countered by a drop in fiscal revenue by approximately the same amount. The poor revenue performance can largely be attributed to a reduction in non-tax revenues, specifically the transfers received from the Suez Canal Authority and the Egyptian General Petroleum Company. Consequently, the fiscal balance was in significant deficit in 2000, at 3.6 percent of GDP.

27. ***Financing of the expenditure program.*** The Government finances its expenditures through tax revenues, transfers, foreign assistance and borrowing. Revenues covered 87 percent of total expenditures and the remainder was borrowed domestically. Tax revenues financed over half of expenditures in FY2000, while non-tax revenue – largely transfers of profits from the Petroleum Company, the Suez Canal Authority, and the Central Bank – covered another 21 percent. The remainder of government revenue is composed of contributions from local sources and cost recovery proceeds. The Government recognizes that future development of Egypt's tax system will be critical to future financing of government expenditures, especially given the downward trend in the transfer of profits and the eventual decline in customs duties. The authorities are identifying a tax reform program that could be initiated within the next several months.

28. ***Description of the budgetary process.*** The budget process has five main stages. The first stage is the negotiation stage at the working level among the Governorates, line ministries, and the MOF, which is completed by end-December. Stage two is at the Cabinet level; a draft consolidated budget is submitted to the People's Assembly by end-April. The third stage involves discussions, modification, and final approval by the People's Assembly, which takes place prior to end-June. The fourth stage is the disbursement, implementation, and monitoring of the budget, which occurs over the course of the fiscal year. The fifth stage is a review of the execution of the budget by the Central Audit Organization.

29. ***Areas for improvement.*** The budget is a key instrument in allowing the Government to implement its policies. However, at present the budget process itself creates obstacles that inhibit changes the Government desires to introduce. The present budgetary process focuses excessively

on managing financial flows, rather than on attempting to build a process which ensures the adoption of expenditure patterns that implement government policies or on achieving the best possible results within the budget allocation. Specifically, the present budget process discourages (i) prioritization of the expenditures; (ii) achieving cost savings in service delivery; (iii) transparency; (iv) comprehensiveness; and (v) results orientation. This section discusses why these results occur and what could be done to improve upon the situation.

30. ***Steps towards result-oriented budgeting.*** Public sector performance could benefit from the greater emphasis on effectiveness of service delivery, already high on the agenda of the Ministry of Finance. While the overall reform process will take time, there are a number of measure that could be taken in the very near future and that would greatly enhance the result orientation of the budget. Some initial steps could be: (i) agree and publicly announce a medium-term macro economic framework with overall and sectoral binding budget ceilings for the next budget cycle and indicative budget envelopes for the coming two years. Reflect these agreements in the Budget Circular; (ii) make the budget documents and the reports on budget execution available to civil society in a timely manner; (iii) introduce an effective expenditure tracking system, based on appropriate information technology, so as to better monitor budget execution; (iv) unify the budget management for the recurrent and the investment budget; (v) launch pilots to introduce a more results oriented budget process in selective agencies; this will require that their budget classification and nomenclature be adjusted and that they define their desired budget outcomes and the indicators that will be used to monitor progress.

Chapter V: Employment and Welfare Developments

31. This chapter discusses three areas of greatest relevance for understanding the plight of the poor: (i) employment and wage trends, (ii) levels of poverty; and (iii) public expenditures on education, health, and safety nets.

32. ***Labor force growth.*** The labor supply will continue to grow in the medium-term at a robust pace, estimated at 2.6 percent for 2001-2010 compared to 2.7 percent during 1988-1998. Though the absolute number of new jobs seekers will rise until 2006, the rate of growth is forecasted to decrease beginning in 2001. For the next ten years, the average number of new market jobs required annually is about 638,000 per year compared to 508,000 jobs created annually in 1997-1999. In the next decade there will be significant changes in the composition of the labor force, with (i) more educated labor, (ii) a higher proportion of women, and (iii) a larger presence of rural-based labor.

33. ***Unemployment and underemployment.*** Egypt's official unemployment rate of 7.4 percent for 2000 appears modest in comparison to other developing countries. In part, this may reflect an under estimation of the labor force. The most rigorous unofficial estimate of unemployment rates available are 11.7 percent of the labor force in 1998 when limited to market-based employment. This falls to 7.9 percent when the extended labor force definition (which includes women engaged in subsistence agriculture) is adopted. The rate of under-employment was 3.4 percent of the labor force. Under-employment primarily affected rural males, especially less educated labor engaged in casual labor (i.e., irregular jobs).

34. ***Who are the unemployed?*** The highest rates of unemployment are among young educated adults – both male and female – seeking their first jobs. These new job seekers in both the urban and rural areas have unemployment rates close to 15 percent, with the exception of young urban women (15-30 years) whose average unemployment rate is closer to 25 percent. By the age of 30-35 years, unemployment falls to about 5 percent. Educated labor, especially those with

degrees of intermediate and above have higher unemployment rates, especially among females and rural males. Thus, it appears that in the rural sector in particular not enough jobs are being created that better educated workers deem suitable.

35. ***Employment creation.*** Employment creation was robust over the past decade and estimated at 2.4 percent during 1988-1998. Job creation in the private non-agriculture and public sectors were high; they contributed 38 percent and 35 percent respectively to employment creation. Though employment creation in agriculture was the slowest, because of its large size it contributed 27 percent of employment during 1988-1998. The aggregate figures for job creation mask the very different experiences of men and women as well as the wage/nonwage composition of jobs created. For every job created in the public sector for men, two jobs were created in the private non-agriculture sector. Wage jobs in the private sector were primarily in manufacturing, construction, and trade and services. On the other hand, men were leaving the agriculture sector in large numbers. Trends in female employment show the majority of all new jobs were non-wage jobs in the private agriculture sector (73 percent) followed by government jobs (25 percent). The private non-agriculture sector created only 2 percent of all female jobs and these were in manufacturing and trade and services.

36. ***Wage trends.*** Real hourly wages over the 1988-1998 period declined in almost every sector of the economy by an average of 3.6 percent and 1.3 percent per annum for males and females respectively. Wages of better paid workers decreased which resulted in compression of the overall wage structure over the decade. Analyses of the labor market surveys suggest that there has been an apparent negative return to basic education, both in terms of employment and wages. In the mid-1990s, unemployment among those with intermediate education was 33 percent, compared with 1 percent for illiterates. Over the 1988-1998 period, there was falling educational wage premium for all but the lowest end (read and write and primary education) and the highest end (university) of the educational ladder.

37. ***Medium-term issues in the labor market.*** What are the main labor market issues that will face the Government in the medium-term? There are three main issues in the medium-term. First, unemployment rates may rise in the future because past high enrollment rates will lead to higher open unemployment among new job-seekers, women are having difficulty finding jobs in the private and public sectors, and the private sector job creation is low during slow growth periods. Second, sustainable wage growth in the future will depend on productivity gains in Egypt. According to sectoral data, productivity grew by 1.4 per annum during 1991-1999. Third, significant increase in earnings could occur independent of wage gains, if women's participation in the work force increased; however, women's employment in the private non-agriculture sector is falling.

38. ***Changes in welfare.*** National accounts data indicate that the Egyptian population in the aggregate experienced an improvement in the standard of living as measured by output and by private consumption per capita. However, peoples' consumption growth slowed in the post-1997 era in comparison to output as the share of investment rose. Poverty estimates for Egypt have not been updated since the mid-1990s when the shares of the ultra and total poor were an estimated 7 and 23 percent of the population respectively. The poverty level in Egypt was above what would have been predicted by regional and development standards, though not overly so. In 1995/96, the distribution of expenditures in Egypt reveals that small changes in income could lead to significant changes in poverty. The average per capita expenditures of persons in the sixth decile (or about three deciles *above* the poverty line) were only 30 percent higher than the poverty line.

39. ***Non-monetary indicators of poverty.*** The two sets of indicators looked at are health and education: (i) Progress in health and nutrition has generally exceeded what other countries at similar initial levels have achieved. Nevertheless, since Egypt has only recently joined the ranks of the lower middle income countries, its indicators are comparatively poor. Despite improvements, the health of young children remains of particular concern. (ii) Progress in eradicating illiteracy over the decade has been the poorest in the region, and poor internationally, given its initial income and illiteracy levels. While adult illiteracy in Egypt has declined over the decade, it remains high, with 45 percent of the population illiterate in 1999. Of even greater concern, about 31 percent of the *young* adult population (15-24 years old) is illiterate, foreshadowing a potentially immense employment problem in the future.

40. ***Public expenditures on the social sectors.*** Over the 1990s, the Government of Egypt has demonstrated a commitment to its social expenditure program, despite embarking upon strict fiscal austerity. At the same time, however, outcomes from the state's two most vital interventions for long-term poverty reduction – education and health care – suggest opportunities for improving efficiency of social sector spending. These social services are also not reaching as high a proportion of the low income groups as the high income groups and therefore, suggesting that more could be done to equalize the distribution of expenditures.

Chapter I

Introduction

1.1. Egypt's output growth was above average for the 1990s compared to the Middle East and North Africa (MENA) region and to lower middle income countries. Indeed, the rapid output growth and the decline in population growth led to a one-third increase in real GNP per capita between 1991 and 2000. Today, with per capita output exceeding US$ 1500, Egypt has joined the ranks of lower middle income countries.

1.2. The growth record in Egypt has not been fully reflected in social outcomes. Despite significant improvement in the last two decades, Egypt's social indictors lag behind comparators in the MENA region and in other developing regions. In particular, illiteracy rates and health indicators, especially for women and children, are below average in comparison with countries of similar income levels. Also, poverty remains a persistent and significant problem in Egypt afflicting about one-fifth of the population.

1.3. A central objective of the Government over the medium- and long-terms is to achieve high economic growth in order to create employment and improve living conditions to meet the expectations of Egypt's young and growing population. In 1997 the Government established a road map for its long-term development in the document entitled *Egypt and the 21st Century.*[1] This economic and social development strategy provides information on the Government's broad policy objectives until 2017 and adopts specific growth targets. One of its major vehicles for improving potential growth is through the expansion of cultivatable land area from about 6 percent to 25 percent of Egypt's land mass by embarking upon several large national infrastructure projects.

I. A Social and Structural Review

1.4. The World Bank hopes to contribute to the Government's development agenda by providing an analysis of Egypt's recent economic achievements and their implications for the medium- to long-term. Within the last few years, the World Bank has developed an analytical instrument for middle income countries called a "social and structural review". Its aim is to identify the strategic policy priorities that are likely to yield the highest returns in terms of poverty reduction and development.

1.5. The *Egypt Social and Structural Review* (ESSR) identifies those priorities by providing a systematic evaluation of economic policy and structure in order to identify (a) the main constraints on poverty reduction and long run development in Egypt and (b) the sources of vulnerability, particularly as Egypt considers further global integration through entering into foreign trade agreements. The report takes a broad approach and discusses a number of important issues but does not address other critical questions due to the lack of adequate information (as noted in section III). The major areas covered in the report are: macroeconomics and growth, employment and welfare, the private sector, and the public sector. But these topics are not meant

[1] *Egypt and the 21st Century* can be found on the web at www.sis.gov.eg.

to be analyzed in isolation, rather the hope is to create an understanding of how one set of policy choices impact other aspects of development.

1.6. The nature of a social and structural review with its focus on prioritizing development constraints and providing in-depth analysis of specific issues makes it of greatest relevance to senior government officials. It also assumes significant knowledge of trends in Egypt's economy as well as an appreciation of the political constraints facing the Government in introducing policy shifts. Though the report is not a stocktaking exercise nor an historical account of economic and structural changes in Egypt, it hopes to be of use to the donor community in informing their discussions on prioritizing financial and technical assistance.

II. Analytical Framework

1.7. Egypt's growth performance in the 1990s was robust yet questions arise regarding its future sustainability unless structural changes are introduced. Growth has been driven by domestic demand rather than through participation in world trade which has underpinned growth in the best performing countries globally. In order for Egypt to continue achieving high rates of growth, it will need to adopt policies that facilitate its further integration into the global economy. In preparation for the increased external competition that will result from the European Union Association Agreement, the business environment will need to be improved in order for the domestic economy to benefit from trade liberalization.

1.8. Has the population benefited from the rapid output growth? Labor market developments, especially employment and wages, are key to understanding the impact of growth on the majority of the population. Higher real wages and more employment opportunities especially at the lower end of the income distribution result in better living standards and less poverty. The quality of life is also heavily influenced by the Government, especially through its dispensation of resources. How well the public sector delivers services to the population, especially lower income groups, will have a direct impact on peoples' well-being. The budget process plays a key role in determining whether resources are channeled effectively and efficiently. Each of the four chapters of the ESSR addresses one aspect of the above areas of concern.

1.9. Chapter II analyzes the sources of economic growth in Egypt and discusses its long-run sustainability and vulnerability to external shocks. The analysis of the sources of growth in Egypt in the past decade reveal that growth has been largely due to the accumulation of labor and capital rather than from productivity growth. This chapter also notes that the Egyptian economy continued to turn inwards: in 1991-1999 the US$ value of world exports grew at 6 percent per annum, while Egypt's exports increased annually by less than 1 percent on average. This inward-oriented growth performance has had negative consequences for the balance of payments. This chapter argues for policies aimed at better integrating Egypt into the world economy.

1.10. Chapter III discusses the challenges to Egypt's global integration and presents an analysis of the existing impediments. It analyzes how the present set of policies, especially the trade regime, has created an incentive framework with an inherent anti-export bias. The substantial protection provided to domestic producers may have hindered productivity growth and access to foreign markets. The Government's decision to sign the EU Association Agreement will open up the Egyptian market to foreign competition and stimulate productivity improvements. The chapter also notes that for domestic producers to be competitive in the new environment, various reforms would have to be introduced to reduce the cost of doing business in Egypt.

1.11. The Government plays an important role in the financing and delivery of social and infrastructure services. Have public expenditures translated into better services to the population? Many Egyptians believe that the quality of basic services could be significantly improved, especially social services. Though the Government may wish to upgrade service delivery, the process through which resources are allocated and spent may hinder achieving this. Chapter IV highlights some reforms that could be undertaken to make the budget process more result-oriented.

1.12. Chapter V traces the evolution of changes in employment, wages, and poverty during a decade that experienced rapid output per capita growth. Developments in the labor market determine to a large extent whether and how the population benefits from economic growth. Even though employment growth exceeded labor force growth, average real wages fell with the stagnation of productivity. Women, in particular, have not fully shared in employment growth which increasingly is being led by the private sector. Since living standards are also affected by the availability of public services, the chapter provides an overview of some of the major issues pertaining to health, education, and the social safety net.

III. Limitations of the ESSR

1.13. Though the ESSR is broad in scope, several important issues are not addressed. The four most obvious are the impact of economic growth on poverty in the latter half of the 1990s, the robustness of the financial sector, the fiscal burden of the large national infrastructure projects, and developments in the corporate sector. Since one of the main objectives of a social and structural review is to identify "the constraints to poverty reduction", the absence of an analysis of the impact of economic policies on the poor is a serious omission. But the lack of household data in the post-1996 period prevents such an analysis. Consequently, throughout the report, labor market developments are emphasized since not only are more recent labor data available, but also labor market outcomes may be a proxy of developments at the individual and household level.

1.14. The second topic not covered in the ESSR is the financial sector. This also presents a problem with the comprehensiveness of the report's conclusions since the financial sector is known to be a major source of vulnerability to long-term growth in developed and developing economies alike. In Egypt, the financial sector is dominated by banks since other forms of financial intermediation are still at an early stage of development. About half of the banking sector's assets are held by four public sector institutions. Information on the lending practices and the quality of the portfolio of these public banks is inadequate.

1.15. Though the implementation of the large national infrastructure projects (commonly referred to as the "mega projects") began several years ago, even now, little is known about their fiscal impact. These infrastructure projects appear to have been off-budget until 1998[2] when the fiscal accounts were revised to include some of the activities of the National Investment Bank which was responsible for investing social security proceeds. Though the sharp increase in the government's capital expenditures in recent years has been attributed to these projects, disaggregated investment data are not available to confirm this. Furthermore, estimates for the remaining project costs are not available. Thus, the report does not take a view on the advisability of the mega projects.

1.16. The fourth issue not addressed is developments at the enterprise level. Though this is a key area for understanding issues such as the investment response of firms to capital market de-

[2] All years referred to are fiscal years unless noted otherwise.

velopment and financial sector stability, data are too scarce for drawing conclusive messages. Despite its significance for determining whether past structural reforms are sufficient for creating a strong foundation for future business development, little work has been carried out in this area. The lack of data affects not only small and medium enterprises, but also the corporate sector.

1.17. As a general observation, data problems appear to be prevalent. Not only are some data absent such as the approved budget or its final accounts, but the quality of statistics also needs improvement. For example, the methodology for calculating the fiscal deficit as well as economic growth could be substantially improved.[3]

1.18. Could the conclusions of the ESSR be called into question because of the quality of data? The short answer is probably not since usually the report's conclusions are drawn not on the basis of any one data set, but rather cumulative evidence from multiple sources. It should be noted that the ESSR does not modify government data series even when obvious problems may exist (such as the under-valuation of tourism's contribution in the national accounts). Official data are used where available, otherwise the analysis is based upon alternative sources of reliable and recent data.

IV. Information Sources

1.19. The scope of the report which touches upon a wide array of issues uses an extensive data and analytical base. Egypt has a sophisticated knowledge base which this report draws heavily upon. The ESSR benefited from the work of Egyptian researchers who have been active in a wide array of topics, including trade, labor markets, and poverty. Donors have been strong supporters of analytical work on a variety of macroeconomic and sector specific topics. Moreover, both the Government and donors have supported surveys which are essential for understanding what is occurring at the agent level – whether individual, household, or firm.

1.20. A few of the main documents that the ESSR draws upon are as follows. The main World Bank reports used are informal macroeconomic policy notes completed within the last year; the task force reports on export promotion, business environment, education and training, and safety nets; and the *Public Expenditure Review of the Social Sectors* (1998). USAID has funded work in many of the areas to be covered in the ESSR including trade, taxation, and private sector development. The UNDP's *Human Development Report* (1996) which was carried out by the Institute of National Planning, the research arm of the Ministry of Planning, provided a useful comparison on the changes of poverty during 1990/91 and 1995/96. Also, labor market analysis under the Egypt Labor Market Project (2000) of the Economic Research Forum for the Arab Countries, Iran, and Turkey was essential for understanding developments in the past decade.

[3] The fiscal deficit was recently revised upwards for fiscal years 1998 and 1999. The growth rate for 2000 is preliminary.

Chapter II

Macroeconomic Developments and Growth

I. Introduction

2.1. Egypt's GNP crossed the US$ 100 billion threshold for the first time in 2000 with an output per capita of about $1500. During 1991-2000, Egypt's economy grew on average by 4.9 percent per annum. The Government's long-term development strategy for 1997-2017 aims to accelerate the rate of growth to 6.8 percent by 2002 and further to 7.6 percent for the remainder of the period. If Egypt were able to achieve these high growth rates, its real GDP per capita would double by 2012.

2.2. This past decade witnessed important changes in the Egyptian economy, many initiated by the Government. In the early years of the 1990s, Egypt implemented an economic reform program which included not only stabilization policies but also significant structural changes to increase private and foreign participation. However, despite significant shifts in policy, the economy turned inwards and the importance of trade declined.

2.3. Can Egypt's growth performance in the 1990s be reproduced in the 21st century? For future poverty reduction, an imperative exists for continued economic growth. This chapter seeks to address the issue of whether Egypt can grow robustly in the future. It analyzes the sources of growth and its sustainability in the medium- and long-terms. It also reviews the sources of vulnerability to future growth.

2.4. The main messages based upon the findings of this chapter are:

- Egypt's economic performance in the late 1990s was robust and in order to maintain performance, the Government will need to continue implementing reforms. Indeed, Egypt's international competitiveness deteriorated in the 1990s because of the substantial appreciation in the real exchange rate and low productivity gains. Economic management needs to be strengthened to enhance growth prospects.

- Economic growth strengthened in the latter half of the 1990s driven mainly by domestic absorption. Growth sectors in Egypt are not technology intensive and have not been associated with large improvements in productivity. Therefore, for Egypt to meet its growth targets, investment levels need to increase significantly and structural reforms deepened to increase productivity and attract more investment.

- Despite recent pressures on the balance of payments (BOP) and the vulnerability of foreign exchange earnings to external shocks, Egypt does not appear to face a BOP crisis as its external debt is low and international reserves cover 8 months of imports. However, fiscal policy should be strengthened to reduce pressures on the BOP and to ensure medium-term sustainability. In this regard, the saving-investment gap could also make the Egyptian economy more vulnerable to external shocks.

II. Economic Developments[4]

2.5. The year 1991 is a pivotal point in Egypt's modern economic history. Egypt embarked upon a stabilization program and took important steps to open up the economy to greater competition and decrease the level of government involvement in economic activities. The GOE was successful in reducing the large internal and external imbalances through improved economic management and by obtaining significant external debt forgiveness following the Gulf war.

2.6. The economy grew on average by 4.9 percent per annum and output per capita increased by 2.9 percent per annum during 1991-2000. The major economic achievements of Egypt in this period were as follows:

- On the macroeconomic front, government policies successfully maintained internal and external balances and contained inflationary pressures for much of the period. The overall budget deficit was reduced from 15.2 percent to 3.6 percent of GDP; the inflation rate fell from 15 percent to 3 percent; and the average current account balance in this period was 1.7 percent of GDP.
- On the structural front, deregulation, capital market reforms, and privatization improved the business environment. Gross domestic private investment increased from 12 percent to 17 percent of GDP; about half of the 314 public enterprises were privatized. In addition, progress was achieved in financial sector reforms including interest rate liberalization.

2.7. Though the new policies adopted by the Government were critical in moving Egypt closer to a private-sector led economy, the performance of exports and FDI remained below expectations. Egyptian businesses appear to have found the domestic market more attractive as did many of the foreign investors who came to Egypt. The protection afforded by the high tariff rates and the appreciating currency discouraged the shift to exploit external markets despite the Government's attempts to give special concessions to both domestic and foreign business. Furthermore, though policies encouraging FDI were adopted and privatization of public enterprises attracted foreign companies, after an early surge in capital flows, these tapered off in the latter part of the decade.

2.8. The imperative for better economic performance comes from the high labor force growth rate of 2.7 percent per annum which implies that annually about an additional half-million workers seek employment. In the 1990s, the private sector's share of employment increased only marginally to about two-thirds and on average it created about 290,000 jobs per year. Since private sector job creation was far less than the number of new job seekers, the Government hired an average of 170,000 workers per year into the civil service in an attempt to reduce the level of unemployment in the short-term. Though official labor statistics indicate that the Government appears to have had some success, unemployment still remains a problem. However, expansion of an already large civil service is unlikely to be a long-term solution to Egypt's unemployment problem.

2.9. In addition to the need to create more jobs, Egypt also faces the challenge of creating better paying jobs which result in higher real wages and improved living standards. Real wages declined during 1988-1998 but there is some evidence that in the recent years they increased. For example, wages in the manufacturing sector have risen by more than 20 percent over the last two years. Estimates of labor productivity, however, indicate that increases in real wages in recent years were not accompanied by labor productivity growth.

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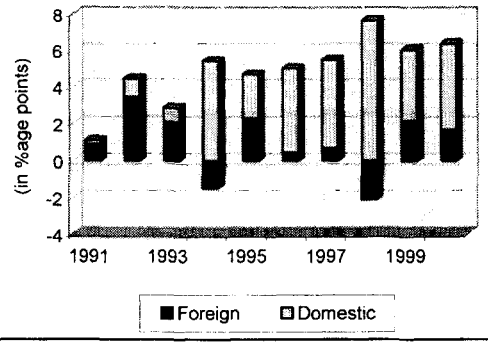
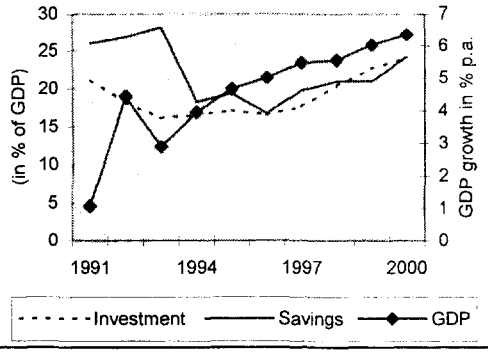
[4] All years are fiscal years unless noted otherwise. The fiscal year 1995 is from July 1, 1994 to June 30, 1995.

Figure II.1: Contribution to Growth of Foreign and Domestic Sectors



Source: Government of Egypt

Figure II.2
Output Growth, Savings, and Investment



Source: Government of Egypt.
Note: Savings refers to gross national savings.

III. Economic Growth

2.10. This section addresses two questions. First, it attempts to identify what caused the high growth rates in Egypt during the 1990s, particularly in the latter half of the decade. In order to answer this question, several aspects of growth are analyzed. The section begins with an analysis of the domestic and foreign contributions since international experience has shown the importance of global integration for long-term growth. Next, there is a discussion of the role of investment and whether growth was driven by factor accumulation or productivity. Finally, we discuss trends in investment and savings as their behavior underpins long-term growth and discuss possible reasons for the recently observed high rates.

2.11. Second, this chapter analyzes supply-side developments, in particular sectoral issues. The sectoral decomposition of growth is carried out by identifying the contributions of the agriculture, industry, construction, and services sectors to growth in the 1990s. This is followed by an analysis of employment trends by sector. Finally, we discuss the impact of exogenous sources of income (e.g., Suez Canal and oil revenue) on the sustainability of future growth.

III.1. Sources of Growth

2.12. Egypt's economic growth in the 1990s was driven by strong Egyptian demand for locally produced goods and services. The contribution of the external sector to growth was small and even occasionally negative (see Figure II.1).[5] Moreover, the domestic sector grew in importance during the decade. For example, in the first half of the 1990s, external demand was 49 percent while in the latter part of the 1990s, its share declined to 9 percent of total demand. The limited importance of the external sector was reflected in the performance of exports which declined from 28 percent in 1991 to 16 percent of GDP in 2000.

2.13. Domestic demand growth in the late 1990s resulted from a significant expansion of consumption and investment. Gross domestic investment and consumption grew by an average of 9 percent and 4 percent respectively per annum in real terms during 1991-2000. The share of investment reached 24 percent of GDP in 2000 according to preliminary estimates. In the high

[5] Standard decomposition analysis is employed.

growth period of 1997-2000, the rise in investment is attributable to both strong private and public investment.[6] Since 1997, the GOE implemented an expansionary fiscal policy and channeled significant resources to capital spending, probably to the mega projects.

2.14. Did higher investment lead to higher economic growth? Or could it have been from another source such as higher productivity from more efficient utilization of inputs or simply that more people with better education were working? During 1995-2000, Egypt's physical capital grew by 6.9 percent and human capital-adjusted labor[7] by a lower rate of 3.2 percent – and 2.7 percent growth in employment. Analysis of the determinants of growth indicates that in the 1990s, physical capital accumulation (e.g., acquisition of machinery, equipment, and buildings) explains about two-thirds of Egypt's economic growth while increased human capital-adjusted labor explains one-third. The contribution of "total factor productivity" which reflects more efficient use of inputs was negligible for this period.

2.15. Why does it matter that Egypt's growth was a consequence primarily of physical capital accumulation? The reason is that if the Government wishes to attain even higher growth rates in the long-term than those achieved in the recent past, then additional financing for investment will need to be found. For Egypt to attain the GDP growth targets of 7.6 percent established in the long-term development strategy, the ratio of investment to GDP after 2002 will need to rise to between 27 percent to 35 percent depending upon the choice of the incremental capital output ratio.[8]

III.2. Developments in Investment and Savings

2.16. During 1996-1999, investment expenditures in Egypt grew by 19 percent per annum in real terms. But as can be seen in Figure II.4, beginning in 1998, (private) stocks began to pile up reaching 12 percent of total gross domestic investment in 1999. Gross fixed investment grew fast, but by a more modest rate of 16 percent per annum. However, a word of caution at this point: though investment did indeed increase substantially, questions about the quality of investment remain unanswered. Thus, it is difficult to determine the extent to which private capital expenditures resulted in true investment rather than in accumulation of non-performing assets, especially in the construction sector. Furthermore, data on the composition of investment, even at the broad sector level are not available.

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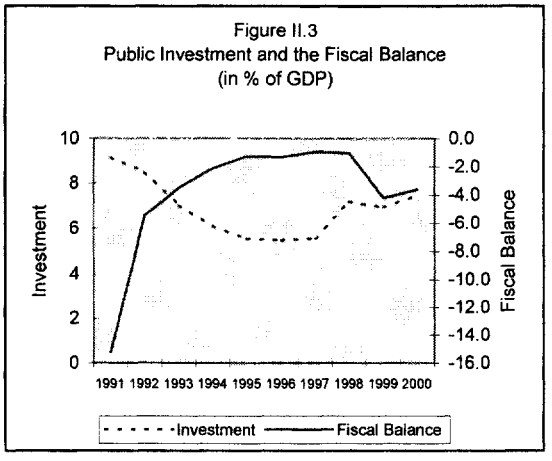
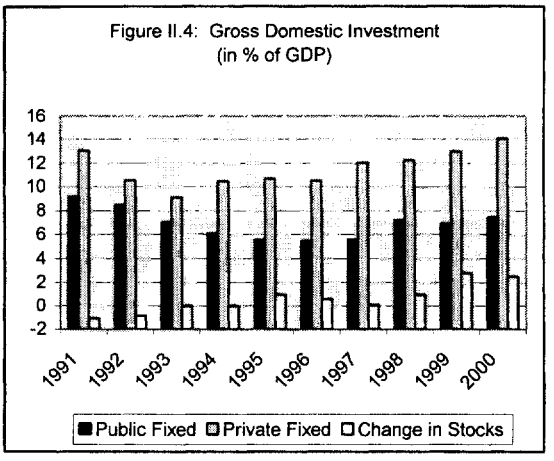
[6] Egypt's national accounts do not disaggregate investment into private and public components. As a proxy for public investment, capital expenditures from government finance statistics are utilized. The residual is considered to be private investment though this may over-represent actual levels since it includes state-owned enterprises.

[7] Human capital-adjusted labor incorporates the contribution of education and size of the labor force to labor input, see Ghosh and Kraay (2000).

[8] The lower investment to GDP ratio of 24-27 percent is based on the assumption that the incremental output to capital ratio (ICOR) will remain constant at 3.82 (the average ICOR over 1995-1999). The required ratio would increase to 26-29 percent and 31-35 percent if the ICOR was 4.1 (average 1999-2000) and 5 respectively.



Source: Government of Egypt



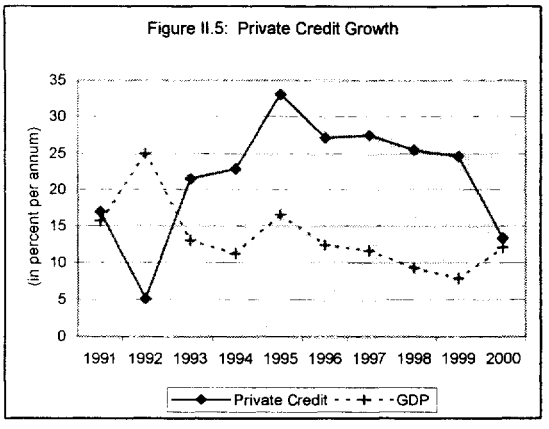
Source: Government of Egypt

2.17. What were the underlying factors that led to the rapid growth in investment? The reasons behind changes in public and private investment differ. Public investment is determined by the Government and constrained by fiscal balance targets and debt management issues. In Egypt, after a sharp fall during the early years of the stabilization program, public investment rose rapidly in the latter part of the 1990s erasing the gains in containing government overall expenditures made by declining interest payments and recurrent expenditures. It also appears that the fiscal targets were relaxed since the deficit began to climb rapidly.[9]

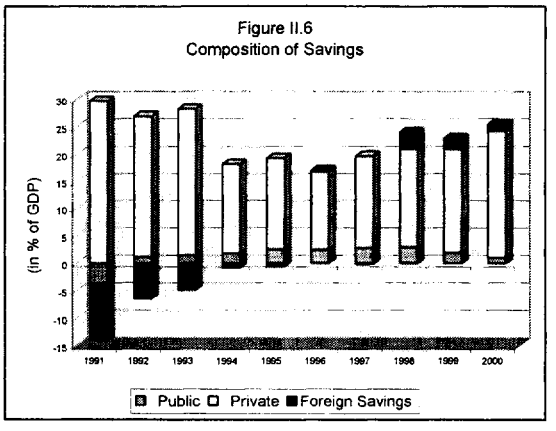
2.18. Private investment is responsive to economic conditions and, in the case of Egypt, three factors appear to have been particularly important. *First,* macroeconomic stability appears to be a key factor indicating that there was a substantial payoff to the economy from the Government's austerity measures and structural changes. Beginning in 1997, private investment took off with its rate of growth exceeding that of GDP. This occurred after several years of sustained and accelerating economic growth, a non-volatile macroeconomic environment with steadily falling inflation and a stable exchange rate. Moreover, private fixed investment increased following two consecutive years of a decline in the inventory stocks.

2.19. *Second,* the decrease in the cost of investment funding may have played an important role in the rise in private activity. The currency appreciation is one major source of declining cost of capital investment. With the real appreciation in the Egyptian pound, importing equipment and machinery from abroad was significantly less expensive than in the early part of the 1990s. Another source of the decline in investment costs was the growth in the access to credit. Nominal credit growth during 1994-1999 to the private sector averaged twice nominal GDP growth–which is high by international standards. It should be noted that rapid credit growth to the degree experienced in Egypt requires a financial sector with the capacity to undertake proper risk assessments of projects. The investments made were also focused on serving the domestic market rather than on export expansion which raises questions about the profitability of these projects.

[9] The fiscal accounts beginning in 1998 were revised to include the expenditures of the National Investment Bank (NIB). Consequently, there is a break in the series in 1998 and prior to that date, total expenditures, especially capital expenditures, may be under-represented. Furthermore, the fiscal account data are still under review while NIB accounts are incorporated properly into the budget.



Source: Government of Egypt



Source: Government of Egypt
Note: Public and private savings refer to gross national savings.

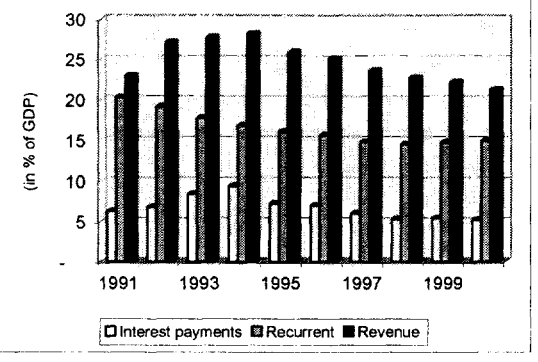
2.20. A *third* possible reason is privatization which may have led to higher private investment. The new owners would have increased capital expenditures in order to upgrade their recently acquired assets. Beginning in the latter half of the CY1996, the privatization program began to be fully implemented. However, this is speculative since data on investment by the privatized firms is not available.

2.21. For ensuring the future sustainability of investment, the continued presence of adequate savings is essential. In Egypt, gross national savings picked up in 1997 and remained high for the remainder of the decade. As with investment, the factors behind changes in public and private domestic savings differ. Despite substantial gains made by the Government in reducing recurrent expenditures, including interest payments, public savings declined after an initial rise during the mid 1990s. The main factor behind this was falling current revenues in GDP which fell from 28 percent to 21 percent in 1993 and 2000 respectively. The determinants of private domestic savings are less clear. International experience suggests that private savings appear to follow rather than precede investment and growth and that they are not responsive to interest rate liberalization.[10] Finally foreign savings contributed about US$ 1.8 billion per annum during 1998-2000 a significant improvement compared to the early 1990s.

2.22. Egypt's savings are low compared to lower middle income countries: 21 percent and 29 percent of GDP respectively. Consequently, further analysis is needed to understand the divergence between Egypt and comparator countries. Important questions, not touched upon in this report, on savings are: what are the determinants of savings in Egypt; how much have savings contributed to growth; and what policy measures could be taken to raise national savings. An empirical analysis which helps to shed light on understanding the reasons behind Egypt's below average savings rates accompanied with an institutional analysis of key organizations (e.g., social security funds) may be particularly useful for provide the Government with directions for reform.

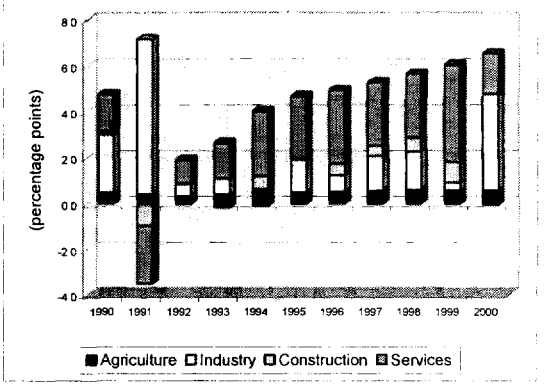
[10] See K. Schmidt-Hebbel, L. Serven, and A. Solimano (1994) "Savings, Investment, and Growth in Developing Countries: An Overview", Policy Research Working Paper 1382, World Bank, Washington, DC.

Figure II.7
Sources of Pressures on Public Savings



Source: Government of Egypt
Note /1: Recurrent expenditures exclude interest payments.
Note /2: Revenue refers to current revenue.

Fgiure II.8: Sectoral Contributions to Growth



Source: Government of Egypt

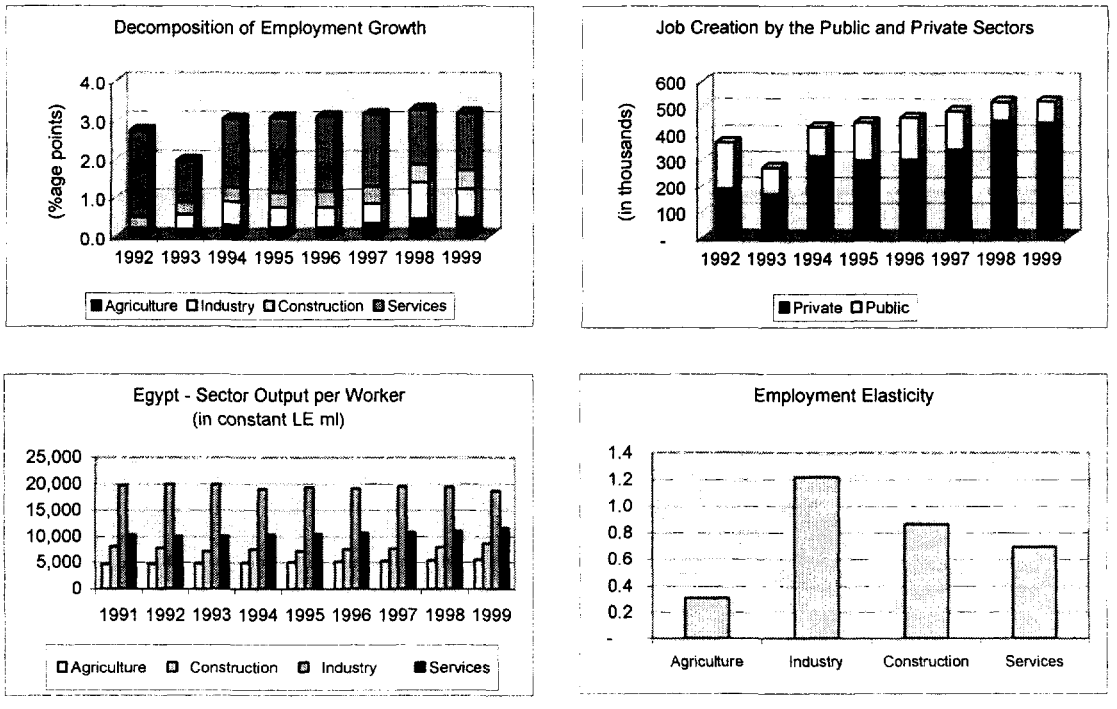
III.3. Sectoral Decomposition of Growth

2.23. Decomposing growth on the supply side indicates that growth has been uneven among sectors. The most dynamic sector has been services which boomed in Egypt in the post-stabilization period, growing at 5-6 percent per annum during 1994-1998 and increased to 8.2 percent in 1999. However, in 2000, the contribution to GDP fell to only 1.7 percentage points, the lowest since 1993, as growth in the sector slowed significantly. Manufacturing also performed well, in particular since 1998, when the sector has been growing at almost 10 percent per annum and contributing almost 2 points to GDP growth. The construction sector has been the fastest growing sector with double digit growth rates since 1995, except in 2000 when growth collapsed to a small but negative rate. The agriculture has been a steady component of growth throughout the 1990s contributing an average of 0.5 percentage points to GDP. Finally, the mining sector, dominated by oil, has been quite volatile, especially during 1999-2000.

2.24. Despite Egypt's economic performance, the composition of growth was based primarily on low value added output consumed by internal consumers. The most dynamic sectors in Egypt are non-tradeables with the exception of the manufacturing sector. Services has been the most vigorous sector. Construction also grew at a high rate during 1995-1999 and was an important component of investment. The collapse of the construction boom in 2000 raises concern because it may have been heavily financed by bank credit, thus adversely impacting the overall quality of the banks' portfolios.

2.25. The sectoral composition of growth also indicates that significant incorporation of modern technology did not occur, expect perhaps in some manufactures. Though allocation of investment by sector is not known, the high growth in construction suggests that this sector may have absorbed significant funds. This further suggests that investment went predominantly into new buildings rather than re-tooling or capital investments. Even though there were modest FDI inflows, they like domestic firms were not a source of technological change that would be necessary for upgrading Egypt's competitiveness and productivity.

Figure II.9



Source: Staff calculations based on Government of Egypt data.

III.4. Composition of Employment Growth

2.26. During 1991-1999 the Egyptian economy created on average 436,000 jobs annually, equivalent to a job growth rate of 2.9 percent per annum. The employment to output elasticity is 0.64 in this past decade. This elasticity is well above the average observed in Egypt during the 1960-1990 period of 0.47 indicating that the economy's ability to generate jobs has increased.

2.27. A decomposition of employment creation by sector shows that the services sector continues to provide the largest contribution followed by industry. The contribution of the services sectors, however, has decreased significantly from creating 61 percent of all new jobs during 1994-1997 to 45 percent during 1998-1999. This decline was most probably the result of the diminished role of the public sector which instead of creating one-third of all new jobs in the mid-1990s, created only about 14 percent in 1998-1999. Employment growth in the construction sector has been the most rapid but from a small base – annual job creation in this sector is about 77,000 jobs in 1998-1999. The contributions of industry and agriculture have increased in the last two years compared to earlier in the decade. Agriculture has been a steady contributor to employment growth in absolute terms creating between 4-5 million jobs in the last decade. As seen in Chapter III, this amount may even be underestimated, once non-wage female job creation in the agriculture sector is taken into account.

2.28. Employment creation and average wages could be increased significantly by promoting policies which encourage the expansion of the manufacturing sector. In comparison to other lower middle income countries whose manufacturing sector average 27 percent of GDP, Egypt's manufacturing sector is small at 19 percent. Also, manufactured exports are only 44 percent of all merchandise exports (already low) in Egypt as compared to 66 percent for comparator countries. The industrial sector has the highest employment elasticity among all sectors in Egypt

indicating a large untapped source of job creation potential. Also, wages are probably the highest in this sector since it has the highest average productivity as measured by output per worker. Consequently, if workers have the opportunity to work in manufacturing due to new job creation, their wages would rise significantly.

III.5. Structural Developments and Implications for Economic Growth

2.29. Will Egypt be able to sustain the pace of economic growth in the medium term? The answer to this question depends upon what structural changes are introduced to the economy since major underlying transformations are already occurring. What is unlikely is that future economic growth will be driven by domestic demand to the extent it has been in the past several years. A consensus exists in Egypt that the current economic system must evolve towards greater openness through broader private sector participation in the formal sector, especially in the export and high-tech sectors. There is less agreement on how this should be achieved.

2.30. The far-reaching transformation underway in Egypt is the declining importance of quasi-rents[11] in the economy. These revenues accrue as a consequence of Egypt's unique strategic, geological, and historical features. Suez Canal tolls, oil export earnings, and worker remittances fall into this category as does economic assistance averaging over US $2 billion per year. Even as oil exports decrease with the rise in domestic consumption, Egypt is likely to become a major exporter of natural gas by 2004 given its large reserves.[12] The quasi-rents accounted for 10 percent of GDP in 2000 compared to about 23 percent in 1991. The value of the rents as a share of the import bill has fallen from 44 percent to 33 percent, but the gap has been filled by tourism receipts rather than merchandise exports.

2.31. Though quasi-rents have helped to finance public services and private consumption in Egypt, they may also have had two undesirable consequences. First, quasi-rents could have reduced the pressure to implement the wide array of reforms needed that would enhance the competitiveness of manufactures. As indicated earlier, Egypt's manufacturing sub-sector's value-added is about 19 percent of GDP compared to 27 percent for lower middle income countries. Thus, despite significant structural reforms adopted in the past two decades, Egypt's industrial and manufacturing production lags behind comparator countries indicating the need to implement additional reforms to facilitate private sector development (discussed at length in Chapter III).

2.32. Second, quasi-rents of the magnitude received by Egypt could have undermined the competitiveness of Egyptian producers in international markets, especially the profitability of the agricultural and non-resource based industrial sectors, by strengthening the national currency. The importance of non-resource based industries for a country's development is that it usually offers better opportunities for long-term productivity growth than specialization in primary goods (e.g., oil or gas) or export of labor. In Egypt during 1991-2000, the real exchange rate is estimated to have appreciated by about 70 percent while the share of exports in GDP fell substantially. Moreover, Egypt's export performance in goods and services lags behind that of comparator countries: 16 percent of GDP compared to 32 percent for lower middle income countries in 1999. Egypt's merchandise exports are also significantly lower in comparison with the same comparators.

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[11] Exogenous sources of income.

[12] See *Privatization in Egypt. Quarterly Review*, Privatization Coordination Supporting Unit, Cerana Corporation, Cairo, July – September, 2000.

IV. Economic Management

2.33. The balance of payments (BOP) has been under pressure since 1998 following the impact of exogenous shocks on oil and tourism revenues. The initial effect was on the current account which fell into sharp deficit in 1998. Although the current account improved subsequently in 1999 and 2000, the capital account deteriorated sharply, especially in 2000, and the overall balance of payments went into deficit. As a result, Egypt consistently lost international reserves during 1998-2000 such that the initial stock fell by 25 some percent, reaching US$ 15 billion in end fiscal year 2000. Notwithstanding this, Egypt does not appear to face a short-term risk of a BOP crisis since reserves continue to be adequate to cover imports for 8 months and external debt can be serviced. In particular, short-term debt is relatively low. There is still concern, however, whether the recent policies implemented by the authorities will be enough to stem the loss in reserves while these are still strong.

2.34. Pressures on the BOP are not an uncommon occurrence in countries with growth driven by factor accumulation rather than productivity gains and, thus, requiring foreign savings to finance the domestic savings-investment gap. In Egypt, the pressures also reflect the vulnerability of the BOP to external shocks due to Egypt's heavy reliance on quasi-rents (e.g., Suez Canal fees and oil revenues) and tourism receipts which combined constitute 28 percent of current receipts.

2.35. The initial conditions facing Egypt going into the BOP downturn were generally favorable except for concerns about the economy's competitiveness and the consistency of monetary and exchange rate policies. Overall, macroeconomic policies were favorable: the fiscal deficit was small (1 percent of GDP) and inflation was declining. However, Egypt's external competitiveness suffered during the 1991-1997 period with the appreciation in the average real effective exchange rate (hereafter referred to as real exchange rate). At the beginning of the stabilization program, the Government adopted a pegged exchange rate to the US dollar in nominal terms without any flexibility. The inflation differential between Egypt and its main trading partners in Europe and North America led to the appreciation of the Egyptian currency, but could be considered consistent with external equilibrium because of the major Paris Club debt write off which effectively reduced the size of the trade surplus needed to meet debt service. A second concern emerged which was the consistency of the fixed peg with high private credit growth of about 28 percent.

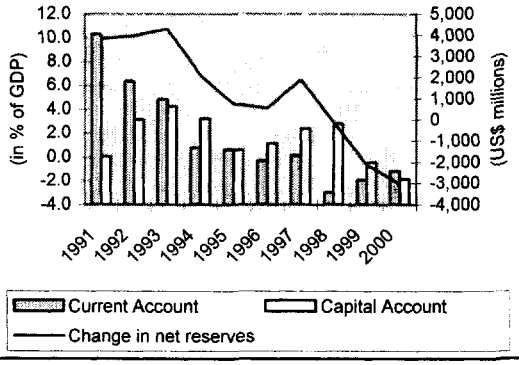
IV.1. Government's Policy Response to the Balance of Payments Pressures

2.36. How and when did Egypt respond to the sudden change in the balance of payments in 1998? In 1998, hoping that the pressures on the current account were only temporary, the authorities instituted "administrative controls" on the exchange rate in order to slow the growth of import payments. Since this proved insufficient to defend the exchange rate peg, the authorities began to draw down international reserves. And as the improvement in the current account was counteracted by a sharp deterioration in the capital account and hence it became clearer that BOP pressures were not going to subside soon, the authorities implemented additional policies.

2.37. Overall, the policy response of the Government to the BOP pressures was muted and at times contradictory as it struggled to maintain at the same time the exchange rate peg and its growth objectives. The most inconsistent action was the adoption of an expansionary fiscal policy during this period. According to official data, the fiscal deficit increased from 1.0 percent in 1998 to 4.2 percent of GDP in 1999. However, since the fiscal data prior to 1998 have not been revised to take into account expenditures financed through the National Investment Bank, the degree of expansion may well be overstated. Nevertheless, even in 2000, the fiscal deficit was

large, at 4.6 percent of GDP. Although the authorities have announced their intentions to reduce the fiscal deficit in 2001, the initial numbers are not encouraging and the fiscal deficit is unlikely to fall. A possible reason that the Government pursued fiscal expansion despite the potential impact on the exchange rate was the reluctance to slow the implementation of the mega projects, a key element in the GOE's long-term development strategy.

Figure II.10
Egypt - Balance of Payments Developments



2.38. Monetary policy may have also increased the pressure on the exchange rate peg for much of this period. During 1998-1999, credit growth remained high; indeed credit grew faster during this period than prior to the BOP pressures. The growth in "quasi-money" increased significantly in 1999 by 11 percent.[13] Moreover, the banks' net domestic assets increased by 24 percent in 1999 due to the expansion of credit to the private sector, particularly of local currency lending. To finance this, banks drew on their foreign assets in 1998-1999. Perhaps because the BOP pressures did not abate as hoped for, monetary policy was finally tightened in 2000 to defend the exchange rate. Credit and reserve money growth slowed. The rate of change in money declined from 12 percent in 1999 to 2 percent in 2000 while total liquidity growth slowed from 11 percent to 9 percent.

2.39. In early fiscal year 2001, the authorities finally relaxed the exchange rate peg and allowed the exchange rate to depreciate. In January 2001, the Central Bank of Egypt (CBE) declared a new exchange rate policy which nominally pegged the Egyptian pound to the US dollar at LE 3.85/US$ but introduced a band. Under the new "managed peg system" a "central rate" is established by the CBE and calculated on the basis of the weighted average of all transactions executed in the market over the previous three weeks. Dealers and banks are allowed to trade at rates 2 percent above or below the central rate. According to the authorities, the depreciation of the exchange rate was driven by currency speculation which was spearheaded by the foreign exchange bureaus. The Government closed down several foreign exchange bureaus and continues to favor administrative controls to restrict imports.

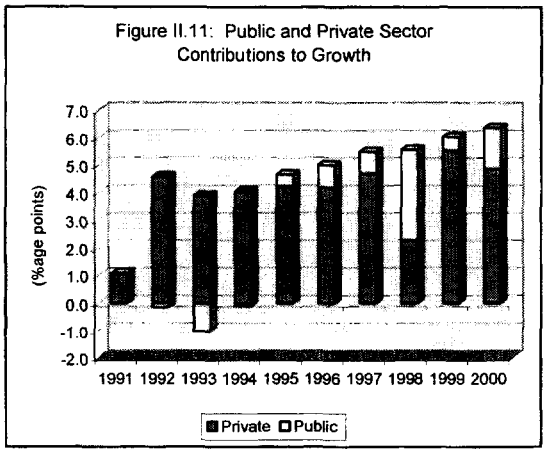
2.40. The advantages of the new exchange rate policy is that it implies a built-in flexibility in the exchange rate regime. However, it carries the risk that a parallel market for foreign exchange may emerge in Egypt if the new system is not managed according to the supply and demand for foreign exchange. Early implementation of the new regime did not see changes in the central rate and at the same time foreign exchange dealers have been restricted to transact within a very narrow band from the central exchange rate.

IV.2. Short-term Consequences of Government's Policy Response

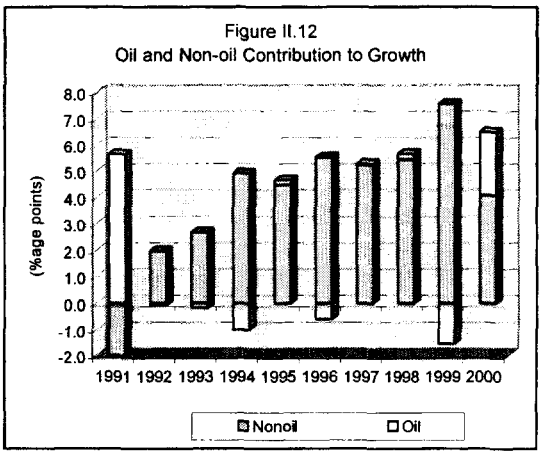
2.41. There have been three consequences of the Government's policy package pursued since 1998: (i) a liquidity squeeze; (ii) increased dollarization; and (iii) a slow down in the non-oil economy of Egypt. Net reserves appear to have stabilized in December 2000 over the previous

[13] Nominal GDP grew by 8 percent in this period.

quarter, but it is still too soon to tell whether this represents a cessation or merely a pause in the downward trend.



Source: Staff calculations based upon GOE data.



Source: Staff calculations based upon GOE data.

2.42. Though the tight monetary policy pursued in 2000 helped ease the pressure on the exchange rate temporarily, it was one of the two main factors that contributed to a domestic liquidity squeeze in 2000. Many of the rates under the control of the Government (T-bills, postal saving deposits, and investment certificates) saw only modest appreciation by about a one-half percentage point. But the overnight interbank rates increased sharply from 9 percent in September 1999 to 15 percent in January/February 2000. Another factor that probably exacerbated this situation is the accumulation of payment arrears by the Government which were officially estimated at LE 16.8 billion in 2000 or 5 percent of GDP. Though the arrears are believed to be caused mainly by the rapid implementation of the mega projects, little information on the arrears is available: whether they were included in the fiscal deficit numbers, what portion have been paid off, to whom, and with what revenues.

2.43. As the liquidity squeeze led to many complaints from the private sector and fears of a sharp decline in economic activity (see below), monetary policy was eased again since the middle of 2000. Inter-bank rates declined during this period, although the easing of credit demand in line with the decline in non-oil economic activity (see paragraph 2.45) may have also played a role in the fall in interest rates. Combined with the continued expansionary fiscal policy, the easing of monetary policy may once again lead to pressures on the balance of payments.

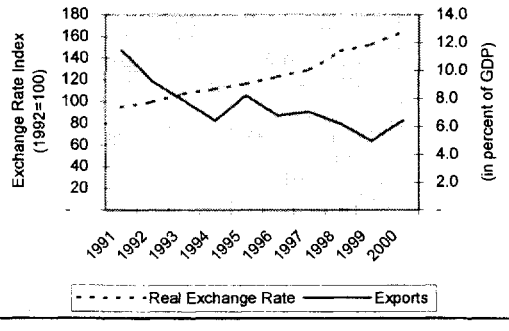
2.44. With the sustained pressure on the currency, the interest on US dollar deposits increased significantly in 2000 to more than 6 percent per annum and led to a narrower interest rate spread against local currency deposits of 3 percentage points. The twin effects of narrowing interest rate spreads and the declining international value of the pound have recently increased the rate of dollarization from 16.8 percent in July 1999 to 18.9 percent in September 2000. Though the level of dollarization is well below the levels seen in the early part of the 1990s, the growth of foreign currency in the money base has been very rapid during the last two years.

2.45. Questions by the private sector and other observers have in particular been raised about the economic growth rate for 2000 which was estimated at 6.4 percent. Even within the Government, there has been a discussion of a recession. However, there are no alternative empirical estimates of economic growth. Other evidence about the real economy such as demand for electricity, cement, and steel appears to indicate that there has been no slow down in the economy.

Decomposing growth into its public and private components may shed some light on why there is a perception of a slowdown. The private sector's contribution to growth fell from 5.5 percent to 4.9 percent between 1999 and 2000. Alternatively, we also see that the non-oil economic growth fell significantly from 7.6 percent to 4.1 percent. Given that most private operators are active in the non-oil economy, the private sector's perception of a slow down is understandable.

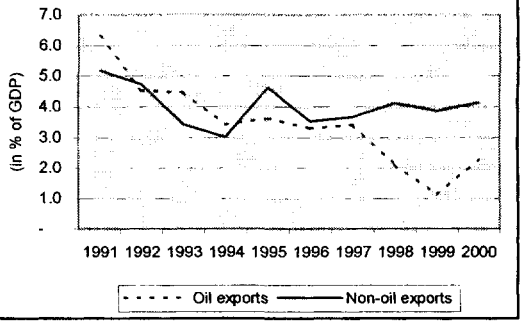
2.46. Overall, Egypt's current economic concerns indicate the need to implement a macroeconomic framework that relies more on the dynamism of international trade to meet growth targets while maintaining external balances. The reliance on administrative controls to control imports will inevitably negatively affect growth prospects. An export oriented strategy would allow the Egyptian economy to grow more without encountering balance of payment pressures.

Figure II.13: Real Exchange Rate and Merchandise Export Performance



Source: RER from IFS, IMF. Export data from GOE.

Figure II.14
Trends in Oil and Non-oil Merchandise Exports



Source: Government of Egypt.

IV.3. International Competitiveness

2.47. Improvement in Egypt's international competitiveness has been stymied with the continued appreciation of the real exchange rate and a lack of growth in total factor productivity. The previous system of a nominal peg without flexibility has led to a real appreciation of the currency because of inflation differentials and more recently because of the strength of the US dollar. Indeed, despite the 14 percent nominal depreciation since the beginning of the adoption of the peg, Egypt's real exchange rate experienced a small appreciation in 1998-2000 period.

2.48. Aggregate data indicate that merchandise exports declined sharply in importance in the Egyptian economy during the 1990s. In value terms, merchandise virtually stagnated during the 1990s, a period during which world merchandise trade expanded by 5.6 percent. Between 1990 and 1998, Egypt's merchandise exports declined from 15 percent of GDP to merely 6.2 percent and its share in total world merchandise exports declined from 0.15 percent in 1990 to 0.1 percent in 1998. But the volatility in the merchandise export performance comes mainly from oil imports as seen in Figure II.14.

2.49. Constant market share analysis, which decomposes growth in exports into various effects, reveals that Egypt failed to take advantage of buoyant world trade (positive world market growth effect) because it did not trade enough in products for which world consumption was growing fast (large and negative world consumption switching effect) and it lost market shares in its traditional

exports products (negative competitiveness effect).[14] TradeCAN (Trade Competitiveness Analysis of Nations) analysis for the 1990s – which breaks down exports into: rising stars, declining stars, missed opportunities and retreats – reveals that Egypt had a significant percentage of declining stars indicating uncertainty about future export opportunities and growth for Egypt. There were also important missed opportunities such as in cosmetics and essential oils. Egypt, nonetheless, managed in the last decade to gain export specialization in as many as 23 product categories and most of these products had a growing share in world imports (rising stars).

IV.4. Data Issues

2.50. The quality, credibility, and timeliness of the analysis of economic management issues are impacted by the data employed. In order to make useful contributions to the policy dialogue in Egypt, the basis of the empirical analysis should be founded upon reliable data. Though there are no alternative sources of measuring GDP and its components, some indication of macroeconomic activity can be found by looking at changes in real variables. Possible measures for assessing economic growth are electricity generation and utilization, cement production and sales, steel bar production and sales, gas production, and tourist arrivals. The trend in these variables over the last few years (1998-2000) has been upwards which is consistent with official data that show a growing economy. However, though these measures are helpful in understanding economic trends, they do not provide a good indication of the magnitude of change. Thus, whether the economy grew by 4 percent or 7 percent in any particular year cannot be verified.

2.51. In addition to past economic performance, data that provide information on recent and near future developments are useful for the private sector in helping to plan investment decisions and for the Government in adopting a strategy to fine-tune economic policy. At present the low frequency of national accounts data and the lag with which they are released make it more difficult to plan and to take any preemptive action. Two steps can be taken to improve the situation. *First*, the Government can increase the frequency of data – to quarterly or monthly – and make it available in a timely manner. The Government has already indicated that it will increase the frequency with which it releases national accounts data. Second, the Government can routinely publish a set of leading economic indicator. This would be particularly helpful in providing the public and private sectors with information on probable events in the near future under present policies.

[14] For a comprehensive competitiveness and constant market share analysis of Egypt's exports, see GOE/World Bank (2000), Volume II.

Chapter III

Opportunities from Global Integration

I. Introduction

3.1. The Government of Egypt has frequently stated that export expansion is a requirement for continued growth of the economy. Egypt's twenty-year strategy, more commonly known as the "2017 Vision", makes clear that integration into global markets through attracting foreign investment and liberalizing the business environment is the only way to meet the Government's objectives of reducing unemployment and maintaining high rates of growth. Future growth in Egypt will depend heavily upon the country's ability to integrate into the world economy.

3.2. The GOE's support for integration has not translated into significantly greater openness of the Egyptian economy. In the past decade, the contribution of the external sector to Egypt's growth as measured by trade has been relatively small and falling. Export share declined from 27 percent to 16 percent of GDP during 1990-2000. Also, during this period, the contribution of the manufacturing sector to the economy grew little indicating that despite the liberalization measures introduced, there was not a significant supply response from the private sector. On the other hand, capital inflows during the 1990s were sporadically high indicating greater openness in terms of FDI and portfolio investment.

3.3. The imperative for economic integration is not only growth, but also the impact on low income consumers and employment creation. Protected markets hurt consumers forcing them to pay prices above international levels. This represents a transfer of resources from the less well-off in society to the affluent. Though protection is given to local industries usually because of the fear that workers will be hurt, instead what usually occurs are missed opportunities for employment growth in high productivity sectors.

3.4. This chapter seeks to identify measures that the Government could take to facilitate the economy's integration into world markets. It is organized into three sections as follows: (i) Egypt's integration into the global economy both in terms of exports and FDI; (ii) internal barriers to exports; and (iii) regional integration issues. Due to lack of adequate information, this chapter does not cover key issues of SME development and corporate governance though they are of critical importance in assuring sustainable private sector development.

3.5. The main findings of this chapter are:

- In order for Egypt to reduce its anti-export bias, it should liberalize its imports by (i) making tariffs more uniform, (ii) lowering tariffs, (iii) eliminating para-tariff charges, and (iv) improving customs clearance procedures. However, trade reform without improving the business environment will not lead to a supply response from the private sector any may even be detrimental.
- Exports did little to help address poverty and unemployment issues in Egypt, as indicated by the stagnant share of labor-intensive products in the export basket over the past decade.
- Egypt is not exploiting the potential of the new international division of labor in which goods are produced at multi-site operations, with the labor-intensive fragments of the production process based in developing countries. For Egypt to join the major international production networks, it will need to lower tariffs on manufactures, reduce dispersion in tariffs, and remove discrimination against parts.

Table III.1
Comparison of Trade Openness Indicators (1999)

	Total Exports (% of GDP)	Manufactured Exports (% merchandise exports)	Manufactured Imports (% merchandise imports)	Unweighted Average Tariff (%)	FDI net inflows (% of GDI)
Egypt	15	37	59	28	6
Tunisia	0	0	0	30	6
Morocco	0	49	58	37	...
Middle East and North Africa	0	21	...	...	2
East Asia and Pacific	0	0	0	...	10
Low income countries	0	52	63	18	3
Middle income countries	0	0	0	14	14
Lower-middle income countries	0	0	0	18	10
Upper-middle income countries	0	0	0	11	19
World	0	0	0	12	...

Source: WDI and Government of Egypt.
Note 1/: Manufactured exports and imports for MENA and low-income countries is for 1998.
Note 2/: Manufactured exports and imports for Morocco is for 1997.
Note 3/: Total exports refers to goods and services exports.

II. Integration into the Global Economy

3.6. In the early 1990s, Egypt undertook significant reforms of the its trade regime. It lowered tariffs, removed many quantitative restrictions, and sought to enter foreign trade agreements to open up its markets selectively. However, despite these measures, Egypt's openness indicators show an economy where significant progress remains to be made in integrating into world markets. Not only does the Egyptian economy remain significantly protected from international competition, but the composition of its exports and imports are skewed away from high productivity goods compared to countries at a similar level of development (see Table III.1).

3.7. Egypt's merchandise exports account for less than 3 percent of GDP in 1999. The analysis in this section looks at the changes that occurred to merchandise exports. We find that two-thirds of these exports are petroleum-related and agricultural materials indicating a fairly undiversified basket. Moreover, 71 percent of merchandise exports in 1999 were based upon Egypt's own natural resource base. Though Egypt has begun to process more of its domestically available primary goods to the final stage, much of this increase came from the petroleum sector. Further analysis also concludes that the aggregate share of unskilled and skilled labor-intensive products fell during the 1990s – which given the increase in processed petroleum-related products would be expected.

3.8. An explanation of specific composition, processing levels, and factor intensities of exports can be found in Egypt's import policies. Given the high cost of imported inputs – well above the international levels – to domestic producers, it is not surprising that exporters who must be internationally competitive in price, instead use the few domestically available natural resources. This may help explain why Egypt has not become part of the three large international production networks (see discussion in that follows in section II.3) and does not produce higher value added goods (excluding processed petroleum products).

3.9. This section presents an overview of Egypt's trade performance in the last decade, an analysis of the export basket, especially of merchandise exports, a discussion of Egypt's participation in the new international division of labor, and selected FDI issues.

Table III.2.
Trade Performance and Openness, 1990-2000

		1990	1994	1995	1996	1997	1998	1999	2000(e)
Exports of goods	in US$ billions	2.6	3.5	3.5	3.6	3.9	3.5	3.6	4.8
Petroleum exports	in US$ billions	0.8	1.4	1.3	1.8	1.8	1.3	1.3	2.1
Imports of goods	in US$ billions	9.2	9.6	11.8	13	13.2	16.5	16	14.1
Ratio of exports to imports	in percent	28.1	36.7	30	27.8	29.7	21.3	22.4	34.4
Openness [a/]	in percent	13.7	12.6	12.7	12.3	11.3	12.1	10.6	9.6
Memorandum:									
Exports of goods and services	in percent of GDP	30.9	27.9	24.2	22.5	22	19	17.5	18.6
Imports of goods and services	in percent of GDP	40.6	36.4	30.6	28	27.4	27.6	24.9	24.8

Source: Derived from balance of payments data, Central Bank of Egypt

Notes: a/ Openness is defined as the percent of trade turnover divided by two of the GDP. The estimate of exports and imports in 2000 based on performance during the first six months

II.1. Trade performance in the 1990s

3.10. Various measures of trade integration lead to the same conclusion: Egypt has lagged behind many developing countries. Trade grew at a slower pace than GDP in the 1990s. Exports in terms of value were mostly flat throughout the 1990s (see Table III.2). According to a preliminary estimate, their value jumped in 2000 by 44 percent due primarily to an increase in oil exports. However, since the contraction in the value of imports more than offset the increase in the value of exports, the total trade turnover fell in 1999 and 2000. With GDP recording healthy growth of around 5 percent in these years, the index of openness—as measured by the share of total trade turnover divided by two in the GDP—further declined.

3.11. Egypt has also lagged in openness behind several countries from Middle East and North African (MENA) region. Most notably, European Union (EU) partners in the MENA, that is, countries that signed Mediterranean Agreements with the EU, have outperformed Egypt in terms of growing openness. The index of openness increased for both Morocco and Tunisia, whereas the degree of openness of Egypt's economy fell from 14 percent in 1990 to 10 percent in 1999-2000.[15]

3.12. Consequently, the 1990s witnessed progressing marginalization of Egypt's position in international markets. Exports were not a force behind its economic growth performance in the past decade. The growth in world trade outpaced change in Egypt's trade. Egypt's share in world exports fell from an average of 0.14 percent over 1980-1989 to 0.08 percent in 1990-1999. It was 0.07 percent in 1998. The share in world imports, albeit significantly higher, also slipped from an average of 0.45 percent in the 1980s to 0.25 percent and amounted to 0.30 percent in 1999.

[15] Although the inclusion of trade in services significantly increases the contribution of foreign trade to GDP to more than 20 percent in 2000, the trend remains the same, i.e., both exports and imports in terms of the GDP significantly fell in comparison with the early 1990s (see Table III.2).

II.2. Egypt's Export Basket: Composition, Processing, and Factor-Intensities

3.13. Egypt's exports are composed of non-factor services (63 percent), manufactures (13 percent), oil (14 percent), and non-oil primary commodities (10 percent).[16] Non-factor services are mostly tourism receipts. The volatility of oil exports has been high due to fluctuations in oil prices. Manufactures actually declined as a share of GDP from 3.5 percent to 2.9 percent in 1990-2000, due in large part to the decline in exports of textiles, yarn, and fabrics (SITC 65). This occurred despite the slight increase in the contribution of the manufacturing sector to GDP in the past decade.

Composition of Merchandise Exports

3.14. Egypt's merchandise export basket is not highly diversified. Despite the liberalization of the economy, including privatization and attraction of FDI, Egypt's exports remain concentrated in a handful of product categories. Petroleum and petroleum-related products accounted for almost 40 percent of Egypt's total merchandise exports and foods and agricultural materials for another 26 percent in 1995-1999. Export concentration in terms of the share of the 25 top products in total exports increased from 52 percent in 1990 to 74 percent in 1999. More diversified exports usually accompany modernization and industrialization of a country and helps make the economy less vulnerable to exogenous shocks.

3.15. The changes that have occurred in the level of processing of Egyptian (merchandise) exports over the past decade may be indicative of the progress in industrialization. Though the export basket does not always capture the progress in industrialization (as domestic markets may provide a more attractive outlet than exports), changes in their intensity in terms of factors of production and composition offer insights into restructuring of domestic industries and their competitiveness in international markets.

3.16. An initial measure of the progress in economic development as reflected in a country's export basket is the extent of increase in the amount of processed goods exports. The US Bureau of Economic Analysis has developed a system that classifies exports in five end-use categories: (i) foods, feeds, and beverages; (ii) industrial supplies and raw materials; (iii) capital goods (excluding autos); (iv) consumer goods (finished household products excluding autos); and (v) automotive vehicles and parts. An increase in the share of categories (iii)-(v) would indicate that the country is producing proportionately more processed goods.

3.17. An examination of changes in Egypt's composition of exports points to the absence of an expansion in exports of more processed goods. The combined share of foods, feeds, and beverages and industrial supplies and raw materials was essentially constant in the 1990s (57.6 percent in 1990 and 58.1 percent of merchandise exports in 1999) indicating a freeze in the level of processing. The share of capital goods in total exports increased, but still accounted for less than one percent of Egypt's total exports in 1999.[17]

Processing Domestically Available Commodities

3.18. Egypt has a rich endowment of natural resources and raw materials (referred to as commodities), such as oil, natural gas, and cotton. Has Egypt increased the level of processing of its

[16] Average for 1995-2000.

[17] On the import side, one should note a significant increase in capital goods from 19 percent in 1990 to 23 percent in 1999. The value of these imports rose from US $1.7 billion to US $3.6 billion.

domestically available commodities? One way of assessing whether a shift has occurred is by analyzing the level of processing of end-use exports, i.e., primary, intermediate, or final. All products that derive their value primarily from a particular commodity are part of a "commodity chain". Thus, cotton, yarn, fabrics, and textiles are part of a commodity chain, whereas a sofa using Egyptian upholstery and cotton filling is not.

3.19. Analysis of Egypt's exports yields two important points. First, a significant shift in commodity exports toward a more processed form occurred (see Table III.3). During 1990-1999, the share of commodities processed to the final stage increased from 25 percent to 37 percent of total export value. This was almost exclusively the result of the increase in processing within the petroleum chain. The value of exports of distillate fuels and gasoline and kerosene doubled in this period, and their share in total final products of commodity chains increased from around 50 percent to almost 75 percent.

3.20. Second, commodity chains continue to play an important role in Egypt's trade regime and comprised 72 percent of total merchandise exports in 1999. The share of the petroleum chain in commodity chain exports rose from 47 to 50 percent. This relatively undiversified export basket makes the balance of payments vulnerable to exogenous shock (e.g., fluctuations in the price of the commodity). Thus, changes in the demand or price of one commodity chain can have significant implications for the growth of the whole economy.[18]

Table III.3
Processing Chains in Egypt's Exports

	1990		1995		1999	
Processing Chains	Value (in US$ ml)	Share (in percent)	Value (in US$ ml)	Share (in percent)	Value (in US$ ml)	Share (in percent)
Primary	806	31	935	27	578	17
Intermediate	426	17	638	19	626	18
Final	658	26	1,015	30	1,304	37
Total/chains	1,890	73	2,588	75	2,508	72
o/w: Petroleum	737	39	1,215	47	1,252	50
All Goods	2,582	100	3,444	100	3,501	100

Source: Staff calculations based on UN COMTRADE Statistics.
Note: Data are based on SITC Rev. 1.

Factor-intensities compared to Factor Endowments

3.21. Egypt's export basket as a whole reflects its factor endowments of abundant natural resources and labor, especially low-skilled labor. There are two emerging developments which are noteworthy because of their wider implication that Egypt's labor intensive products may be losing their competitiveness. *First*, the aggregate share of unskilled and skilled labor-intensive

[18] The expansion in exports of the petroleum chain coincided with the contraction of the cotton chain. The share of the cotton chain declined from 26 percent to 11 percent of total exports during 1990-1999, with the largest fall occurring in intermediate products (mainly cotton yarn). SOEs accounted for 90 percent and 60 percent of spinning and weaving industries respectively. This seems to confirm the observation that SOEs have turned "... the otherwise lucrative sector into one of the Egyptian State's most unproductive industries" (quoted from *Emerging Egypt 2001*, p. 141.)

products fell from 38 percent in 1990 to 29 percent of merchandise exports in 1999. The share of unskilled labor intensive products in merchandise exports fell from 31 percent in 1990 to 24 percent in 1999. *Second*, contrary to its factor endowment but possibly reflecting the large imports of capital goods, Egypt's export of capital-intensive products grew by almost 200 percent during 1990-1999. Since other exports either stagnated or contracted, the share of these products dramatically expanded to 7.8 percent of total merchandise exports, albeit from a low level of 3.1 percent (US$ 261 million).

3.22. What tentative conclusions can we draw from these emerging trends? First, exports could have contributed more to generating employment if labor-intensive exports had performed better. Their production contributes not only to an increase in employment, but, particularly in the case of unskilled labor-intensive production, to poverty reduction. Despite low wages and the abundance of labor, the value of exports of both skilled and unskilled labor-intensive products was lower in 1999 than in 1995.[19] Although capital-intensive exports produce indirect employment effects, it is unlikely that these have fully compensated for the fall in export-related activities in labor-intensive products.

3.23. A second implication of the decline in unskilled labor-intensive exports is that Egypt may be losing its competitiveness in these products. Egypt faces competitive pressures from two fronts. The more advanced developing countries (i.e., third-tier East Asian economies and European transition economies) exert pressure on Egypt through their more efficient production structures, using skilled labor and capital-intensive activities to produce higher valued added and better quality goods. Large, unskilled labor-abundant, low-wage economies (i.e., China, India, and Bangladesh) have been integrating rapidly into the global economy, exerting growing competitive pressures on countries exporting low-skill manufactures such as Egypt. While further research is needed, products from these less developed countries may have crowded out unskilled labor-intensive exports made in Egypt. Without increases in labor productivity achieved through capital investment, Egyptian firms may find it difficult to re-capture their lost share.

II.3. The New Division of Labor – Production Fragmentation

3.24. The nature of competition in international markets has changed over the last two decades with the growth in emphasis on product standards. Successful participation requires a high degree of sophistication by producers for customizing products, rapid innovation, adaptability, and speed of response. The so-called third tier of East Asian economies – Malaysia and Thailand – entered these markets by relying on FDI. Their firms have become part of global production and distribution networks. These networks have arisen due to the outsourcing by many multi-national companies (MNCs) of services and products. The three most important networks are (i) information (i.e., components and final products in office and telecommunication equipment); (ii) automotive; and (iii) furniture.

3.25. The networks exist due to "product fragmentation", that is, the division of an industry's value chain into smaller functions. Thus, firms now are less likely to produce the entire item in-house, but rather contribute to the production, marketing, or the distribution of the products. This provides an opportunity to developing countries such as Egypt to expand exports by developing closer relations with MNCs that have an established and broad distribution network for its prod-

[19] Interestingly, Morocco's exports underwent similar change in the 1990s, albeit its scope was smaller. In contrast, unskilled labor-intensive products drove Tunisia's exports in the 1990s. But as in the case of Egypt, major change occurred in the early 1990s, when the share of unskilled labor grew from 38 percent of total exports in 1990 to 49 percent of total exports in 1995.

ucts. Participating in this new division of labor has many advantages for a firm, such as a higher degree of stability in output demand, lower marketing costs, and greater opportunity to achieve economies of scale.

3.26. To what extent have Egyptian firms become part of these international networks of production and marketing? At present their participation is limited, especially in trade generated from product fragmentation.[20] Exports and imports of parts and components have been relatively small but almost doubled during 1995-1998, achieving a total value in 1998 of US $11.6 million and US $449 million respectively. The increase in the export of parts and components has been due to the slightly higher participation in the information network, especially in telecommunications. Egypt also has a foothold in the furniture network, which can be further exploited. The largest network that remains unexploited is the automotive network; although, Egypt is the Arab world's largest automobile producer, it has not yet developed an internationally competitive 'feeder' industry. High tariff rates and other charges on imports of cars have provided strong incentives to foreign investors to assembly operations rather than specialization in production of parts and components. The absence of VAT further discourages production of parts as imported inputs are subject to taxation.

II.4. Potential for Foreign Direct Investment

3.27. FDI can be an important source of private external finance in Egypt. In general, FDI is motivated by investors' long-term prospects for making profits in production activities they directly control whereas foreign bank lending and portfolio investment is motivated by short-term profit opportunities. In addition to FDI's immediate benefit in raising investment and contributing to capital formation, it is a means of transferring production technology, skills, innovative capacity, and organizational managerial practices. FDI also helps country's access international marketing networks.

3.28. Egypt has the possibility of being attractive to foreign investors because it is the largest potential market in the Middle East region and because of its proximity to European and Arab markets. Yet Egypt's potential to absorb FDI is significantly higher than actual inflows, although there has been considerable improvement since 1997. Egypt's net FDI inflows averaged almost US$ 800 million per year in the last decade, equivalent to 1.3 percent of GDP (see Table III.4, below). However, it is low compared to other developing countries including North Africa, which received on average 2.6 percent of GDP in FDI inflows.[21] Profitability of FDI as measured by the average return of U.S. companies' affiliates located in Egypt was 22 percent that was twice as high as in other developing countries.[22] Thus, Egypt could pull in larger inflows provided the business environment is more hospitable.

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[20] In 1995-1998 the value of the Grubel-Lloyd index was 17 percent, compared to 25 percent for Jordan, 21.4 percent for Morocco, and 23 percent for Tunisia. Egypt's thus mainly relies on inter-industry trade, which tends to be more susceptible than intra-industry trade to swings in demand and highly dependent on cost-of-production factors.

[21] The share of FDI in GDP in Tunisia and Morocco was 2.6 percent and 1.6 percent respectively during 1990-1999.

[22] See *UNCTAD Investment Policy Review. Egypt*, United Nations, New York and Geneva, 1999.

Table III.4
Net FDI inflows to Egypt, 1990-99

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Total	Mean
FDI inflows (US$ ml)	734	253	459	493	1,256	596	637	888	1,077	1,500	7,893	789.3
FDI inflows per capita (US$)	14	5	8	9	22	10	11	15	18	24	135	13.6
FDI in percent of GDP	1.7	0.7	1.1	1.1	2.4	1.0	0.9	1.2	1.3	1.6	13	1.29
Memorandum:												
FDI to developing countries (US$ bl)	31.2	35.3	47.1	66	88.8	105.6	130.1	172.6	176.8	185.1	1,039	103.9
Egypt's share (in percent)	2.35	0.72	0.97	0.75	1.41	0.56	0.49	0.51	0.61	0.81	0.76	0.92

Source: *Global Development Finance*, The World Bank, Washington, D.C., various issues; and *International Financial Statistics*, IMF, Washington, D.C.

3.29. One reason that Egypt may not be able to obtain the level of flows it could is that the investment environment requires significant improvement. Not only are there uncertainties due to the macroeconomic situation (such as the uncertainties in the exchange rate market), but other impediments exist as well. The primary obstacles facing foreign investors are (i) a complex process for establishing companies; [23] (ii) lack of serviced land at competitive prices; (iii) a complex process for site development which requires obtaining multiple approvals including for the investment project; and (iv) inadequate support for obtaining information on investment procedures, government policies and regulations in key areas (e.g., taxation and labor), and data (e.g., economic, sectoral, and financing).

3.30. Notwithstanding the gap between Egypt's potential and actual FDI inflows, foreign investment did not appear to have had any significant impact on Egypt's export performance. Although manufactures have attracted around half of total FDI,[24] their value of exports contracted over 1995-1999, as did their share in total exports. A more detailed sectoral breakdown within manufacturing bears some relationship to the distribution of the FDI stock, albeit a weak one. If anything, this suggests that FDI firms tend to produce for domestic markets and are benefiting from the protection afforded by high tariff barriers.

3.31. Another indication that foreigners may be investing in Egypt to gain domestic market access is the choice of the mode of entry. Foreign firms operating in Egypt rely on joint ventures, rather than wholly owned subsidiaries. Numerous empirical studies show that wholly-owned subsidiaries are more technology-intensive and export-oriented than joint ventures. They also tend to engage in upstream activities (production of parts and components) rather than in production of final products. In contrast, the dominance of joint ventures as the mode of entry suggests that foreign firms investing in Egypt build their competitive edge on brand name (advertising). Major MNCs participating in privatization as "anchor investors" were mainly in products characterized by high advertising intensity (e.g., Pepsico and Coca Cola) rather than research and development intensity.

[23] See *Egypt: A Comparative Study of Foreign Direct Investment Climates,* DEPRA (August 1997). The administrative process of establishing a legal presence is complex, time consuming, and costly. There are at least seven steps involved which require the Government to approve a range of things such as the investor, the corporate form of the business entity, the investment itself, and the location of the investment. However, once a foreign firm establishes itself, the regulatory environment appears to have few explicit biases against foreign firms compared to domestic firms. Foreign firms are allowed to repatriate profits by law

[24] Ibidem.

III. Internal Barriers to Exports: Contestability[25] of Domestic Markets

3.32. The buoyant domestic demand that sustained economic growth in the 1990s is unlikely to provide a similar stimulus in the current decade as discussed in Chapter II. Hence, the challenge ahead is to engineer a shift towards export-led growth by reducing implicit and explicit trade barriers. This would involve introducing measures that:

- Increase competition from imports in the domestic market by liberalizing access. Firms devoid of strong domestic competition have little incentive to improve corporate governance and are unlikely to build the skills necessary to compete in international markets; and

- Facilitate entry of new firms, domestic and foreign-owned alike. This would involve the removal of various administrative and fiscal barriers that keep the cost of conducting business in Egypt high and discourage foreign and domestic investors.

3.33. The lackluster foreign trade performance in the 1990s was a result of the bias against foreign trade in the economic regime. Because of the unfinished agenda of structural reforms, including the trade regime, contestability of Egyptian domestic markets for goods and services remains limited. The remainder of this section discusses (i) the fiscal barriers to entry; (ii) non-fiscal barriers; and (iii) the institutional environment.

III.1. Fiscal Barriers: Tariff Structure and Para-Tariff[26] Measures

3.34. Egypt has high fiscal barriers to imports that provide domestic producers with significant protection from foreign competition and hurt Egyptian consumers. The combined cost of fiscal barriers add 32.3 percent *ad valorem* to the cost of an import on average. The average most favored nation (MFN) applied tariff rate in Egypt is 23 percent excluding alcohol (28 percent with alcohol) which is almost double the average for all IMF members. More significantly, 42 percent of tariff lines have rates above 25 percent. In addition to tariffs, there is an *ad valorem* customs statistical fee (1 percent) and a progressive surcharge[27] on the value of imports of 2-3 percent *ad valorem*.[28] The effective non-tariff payments at border add an additional 4.3 percentage points to the cost of imports.[29]

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[25] Markets are contestable if there is an easy entry of goods, services, capital and people. From an international perspective, contestability includes not only issues of market access for foreign products as embodied in tariffs and narrowly conceived non-tariff barriers, but also market access implications of domestic policies and regulations (e.g., standards requirements, environmental standards, phytosanitary measures) underpinning business activities.

[26] Para-tariffs are additional taxes and charges not directly related to services rendered in import-export transactions.

[27] The surcharge is 2 percent *ad valorem* on products subject to 5-29 percent tariff rates and 3 percent *ad valorem* on products with tariffs exceeding 29 percent.

[28] Since both the customs statistical fee and surcharges bear no relationship to the value of "services" rendered by Customs, they are both WTO-incompatible.

[29] For products subject to the 40 percent tariff rate, the actual customs payments amount to 46 percent of the value of imports. For products subject to higher GST rates the extra costs of imports are considerably bigger. For instance, GST rates on motor vehicles range from 15 to 45 percent. The tariff rate of 40 percent levied on imports of cars with below one-liter engines generates a rate of 56.3 percent ad valorem.

3.35. Are these high fiscal barriers effective in suppressing competition and excluding "unwanted" imports? The large difference between the unweighted average MFN rate (28 percent excluding para-tariffs) and the average import-weighted tariff (14 percent) indicates that Egypt's tariff structure effectively inhibits competition from imports for domestic firms. The unweighted average is much larger than the import-weighted average because of the lower amount of imports of goods subject to high tariff rates.

3.36. Egypt's tariff structure is not only high but also diverges from the ideal of uniformity. The higher the dispersion in tariff rates, the larger are potential distortions, as the variance in tariff rates causes the variation in imported product prices. The overall standard deviation of Egypt's MFN rates of 78 percent is high by international standards. The dispersion is high both across and within various sectors of the economy with the agricultural sector obtaining more protection than manufacturing. The unweighted average applied tariff rate ranged in 1999 between 12 percent for petroleum products, 37 percent for textiles, and 51 percent for food products.

3.37. Since tariffs are not uniform, protection offered to domestic producers is not neutral among products at various stages of processing. The Egyptian tariff structure discriminates against low processed products, leading to very significant tariff escalation, i.e., effective tariffs for fully processed products are significantly higher than tariffs for semi-processed products and raw materials. In 1999, the average tariff on products in the first-stage of processing was 14.3 percent; in the second stage amounted to 21.4 percent and in the third stage to 35.6 percent.[30]

3.38. In conclusion, the peculiarities of Egypt's tariff structure may explain to a significant degree the limited progress in integrating into the world economy in the 1990s. Tariffs on imported inputs together with para-tariff measures are the most important direct barrier to exports. Their high levels contribute to low competition in domestic markets. Furthermore, effective rates of protection in manufacturing significantly exceeding nominal tariffs divert resources away from export to import-substituting sectors. Reforms should address major distortions generated by Egypt's tariff structure. Even a well-functioning duty drawback and sales tax rebate scheme do not substitute for lowering tariff rates and making them more uniform.[31]

III.2. Other Factors Impeding Competition From Imports

3.39. Although tariffs and para-tariff remain powerful instruments of protectionism in Egypt, other factors impede imports and thereby limit contestability of domestic markets. The primary obstacles faced when trying to bring imports into Egyptian territory are customs procedures, administrative controls, and quality controls. Not only do these procedures give undue protection to domestic producers, but they also hurt Egyptian exporters who use imported inputs.

3.40. Customs procedures are cumbersome and make the importation of goods a time consuming and potentially expensive process. The Government is aware of this and by passing Law No. 106 hopes to streamline the inspection process. Nevertheless, the clearance, licensing, and inspection procedures impose an estimated additional cost equal to a 15 percent tariff and take

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[30] The classification of different stages of production was calculated according to the WTO classification used in Trade Policy Reviews.

[31] This is so for three reasons. First, duty drawbacks and rebates to exporters of sales taxes on imported inputs would not reduce domestic prices to world prices. In consequence, there would be *no change in the allocation of resources* towards the export sector. Second, small firms would be excluded, as transaction costs associated with duty drawbacks are high. Last but not least, interacting with customs involves some extra costs, with duty drawback offering extra opportunities for rent seeking.

about 11 days.[32] The steps involved in clearing customs are many and require several reviews, certifications, payments, and compliance with various regulations.[33] The involvement of several government agencies in addition to the Customs Administration makes the processing more complicated. Customs procedures could be improved by moving to a low and uniform tariff structure that would be particularly desirable on the grounds of administrative issues – simplicity and transparency. It eliminates incentives to misclassify products and simplifies customs clearance procedures, and thereby reduces import costs. Also, if the Government introduced performance criteria for custom officials, such as maximum time allowable for customs clearance, more efficient performance may ensue.

3.41. Administrative controls were imposed on an *ad hoc* basis beginning in 1998 as the pressure on the balance of payments increased. The first of two main controls is the ban on entry of re-exported products. The adoption of this rule meant that only imports shipped from the country of origin could be brought into Egypt. Though this control was removed in 2000, less than two years after it was adopted, it does indicate the uncertainty in the trading regulatory environment in Egypt. The second control required importers to deposit the full amount of the letter of credit in domestic currency with a bank, increasing the cost of doing business for importers.

3.42. Quality standards act as effective import barriers. Instead of adopting international product standards, safety regulations, and certification procedures, Egypt has its own rules covering over 400 product categories. These rules often have no equivalents in international standardization and are at odds with manufacturing practices and guidelines worldwide. Further, new rules serving merely as a barrier to trade are often introduced in an *ad hoc* manner.[34] It is estimated that quality control procedures add between 5 and 50 percent to the cost of imports.[35] It seems that benefits in terms of protecting consumers against "dangerous" products are minimal, whereas potential losses associated with the decline in constestability of domestic markets and negative impact on foreign investors' assessment of business climate might be huge.

III.3. Institutional Environment

3.43. It is difficult for an outsider to navigate the country's business environment. This is one reason that Egypt ranks low in various surveys assessing "business-friendliness" of economic regimes.[36] In order to increase domestic competition and new business formation, several areas particularly relevant to public-private interface should be evaluated for reform. These include (i) privatization, (ii) corporate taxation, (iii) the commercial legal system, and (iv) the financial sys-

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[32] *Entering the 21st Century: World Development Report 1999/2000,* World Bank, Oxford University Press: Oxford, 2000.

[33] See *Arab Republic of Egypt. Plan of Actions for Export Promotion. Vol. II: Main Report*, The World Bank, Washington, D.C., 2000, p. 91.

[34] A good illustration is Government Decree 343 (July 1999), which introduced detailed manufacturing requirements including stringent water absorption levels of imported shoes. Considering the rather dry climate in Egypt, its intent was clearly protectionist.

[35] See *Arab Republic of Egypt. Plan of Actions for Export Promotion. Vol. I: Main Report*, The World Bank, Washington, D.C., 2000.

[36] For instance, Egypt with the value of Corruption Perception Index of 3.1 (on the scale of 1 through 10) ranked 63rd among 90 countries surveyed in 2000 (see http//www.transparencyinternational.de). The index provides a good measure of the quality of institutional environment in a country. A World Bank study of various aspects of governance in 155 countries ranked Egypt 100th in government effectiveness, 102nd in regulatory burden, 80th in rule of law, and 103rd in graft (D. Kaufman, A. Kraay and P. Zoido-Lobaton. 1999. "Governance Matters." *World Bank Working Paper No. 2196*).

tem. The remainder of this section discusses major drawbacks of the existing system from the point of view of private sector development and provides some possible options for reform.

Rule-based Public-Private Interface and Privatization

3.44. Although Egypt's public sector still accounts for over one-quarter of GDP and encompasses a wide range of entities and economic activities, significant progress has been made in the transfer of property rights to the private sector. The majority of state-owned enterprises were large firms, whose privatization required considerable effort in design and implementation, because of the need to avoid the "agency" problem ("agency" problems arise when there is separation of ownership and control). Privatization of large firms usually encounters resistance, especially from employees, and legal obstacles. Furthermore, for key utilities, such as telcoms, inadequate information exists on the rules that apply whether for privatization or for the functioning of private entities.

3.45. While privatization was a declared objective in 1991, the privatization program gained momentum only in the second half of the 1990s after the Constitutional Court upheld in early 1996 the right of the Government to privatize public sector enterprises. The share of the private sector in GDP increased from 63 percent in 1996 to 75 percent in 1999.[37] The size of the private sector in Egypt's economy is not low by international standards. Its share of 75 percent would put Egypt on a par with Estonia, which was 'outperformed' in Central Europe only by the Czech Republic and Hungary – in both countries the share stood in 1999 at 80 percent.

3.46. Privatization alone is a necessary but not sufficient condition to enhance microeconomic efficiency, although some gains have already taken place. Economic and financial indicators point to the improved performance of not only enterprises that were transferred to the private sector but also of those that remained under public ownership.[38] The latter no longer constrained by such burdens as selling at controlled prices or hiring in excess of their required labor could concentrate on improving efficiency, whereas the former improved performance due to better management, advanced technology, and more capital investments.[39]

3.47. However, further gains hinge critically on eliminating the State's micromanagement of the economy by introducing clearly defined and transparent rules of interaction between the State and business and continuation of the privatization program especially in the financial sector (see below). Government rules and laws continue to offer the state administration considerable discretion in interpreting and implementing them. Some concerns that should be taken into consideration include the government's retention of controlling shares in some "strategic" industries to act as a quasi-regulator and the limited change in the participation of the private sector, and the need for a more supportive regulatory framework. Furthermore, large, inefficient overstaffed and underpaid civil service deprived of strong professional incentives continues to exercise considerable influence, not subject to clearly defined rules, over the private sector.

[37] Excluding petroleum and government services, the increase was somewhat smaller while the share of the private sector was significantly larger in both years—73.7 percent in 1996 and 85.2 percent in 1999.

[38] See *Privatization in Egypt: Achievements and Challenges*, mimeo, The World Bank, Washington, D.C. June 2000.

[39] Ibidem.

BOX III.1: EGYPT'S PRIVATIZATION PROGRAM

The privatization program started with the enactment of Law 203/1991 which reorganized the public enterprise sector into 17 financially-autonomous holding companies with 314 affiliated companies so as to subject them to market forces and prepare for their eventual privatization. The holding companies are in charge of the financial and technical restructuring of the affiliated companies before bringing them to the point of sale.

After a modest start in 1993 with the privatization of only 6 companies through liquidation, the process accelerated especially during 1996-1998. The privatization transactions have taken place through various methods, including initial public offerings (IPOs), sales to anchor investors, employee shareholder associations (ESAs), liquidations, sales of assets, and long-term leasing. Privatization proceeds until the second quarter of FY00 have exceeded LE 15 billion (US$ 4.4 billion). The privatization program also involved divestiture of the public sector shares in joint-venture financial and non-financial enterprises.

DEVELOPMENTS OF PRIVATIZATION TRANSACTIONS
(Value in LE Million)

Method	1993		1994		1995		1996		1997		1998		1999		July 2000	
	Tra.	Pro.	Tra.	Pro.	Tra.	Pro.	Tra.	Pro.	Tra.	Pro.	Tra.	Pro.	Tra.	Pro.	Tra.	Pro.
IPOs	0	0	3	4	11	1077	19	1988	14	2865	6	1418	0	0	0	0
Majority	0	0	2		5	85	13	1650	12	2519	5	1342	0	0	1	47
Minority	0	0	1		6	992	6	338	2	346	1	76	0	0	0	0
Anchor Investors	0	0	3	433	0	0	3	453	3	447	2	276	9	2766	4	2217
ESA	0	0	7	227	3	139	0	0	3	79	12	351	5	75	0	0
Liquidation	6	0	2	0	2	0	1	0	3	0	6		7	0	3	0
Asset Sales	0	0	0	0	0	0	1	350	1	6	3	316	2	31	2	60
Long-term Lease	0	0	0	0	0	0	0	0	2	..	0	0	6	..	10	..
Total	**6**	**0**	**15**	**664**	**16**	**1216**	**24**	**2791**	**26**	**3397**	**29**	**2361**	**29**	**2872**	**20**	**2324**

Tra.: Transactions. Pro: Proceeds.
Source: Privatization in Egypt: Achievements and Challenges, mimeo, The World Bank, Washington, D.C. June 2000. Primary data from Ministry of Public Enterprises.

The authorities are currently facing the task of selling companies which are less financially and technically viable. Selling these companies will take place through both competitive bidding by anchor investors and public offerings after financial restructuring to ensure maximum participation by quality investors at the highest possible price. However, the state-owned commercial banks are unlikely to be privatized in the current period until broader financial sector restructuring is undertaken, including the strengthening of bank supervision.

In December 1999, the GOE established a restructuring fund, which will receive 50 percent of all privatization receipts to finance early retirement, settlement of debt and corporate restructuring. The budget will receive the other half of the privatization proceeds.

The privatization process is expected to gather further momentum through offering the utilities companies for bidding (telecom and electricity). Private provision of utilities industry, mainly through BOOT schemes, is also underway. There is need, however, to strengthen regulatory capacity in these industries in order to ensure that eventual privatization strategies achieve increased competition and improved services and prices for consumers.

3.48. Addressing regulatory aspects of the nexus between enterprises and the state would contribute enormously to the entry of new firms as well as the restructuring and reorganization of existing firms. Consider, for instance, the regulations to entry to—one should add—an environment that is unpredictable in the application of regulations and laws, once a business has been established. New entrants face huge barriers to entry. A cross-country study, examining entry regulations in 75 countries, ranks Egypt at the bottom of the list as evidenced by the number of administrative procedures, time needed to establish a firm, and the cost involved.[40] Entrant faces in Egypt 17 procedures regulating entry as compared with the largest number of 20 in Bolivia and the smallest number of 2 in Canada. It takes 132 business days to establish a firm in Egypt as compared with 172 days in Mozambique (the worst case) and two days in Canada. It costs on average an equivalent of 2.2 times per capita GDP in Egypt as compared with 2.6 times per capita GDP in Bolivia (the worst case) and 0.0096 times per capita GDP in the U.S. (the best case). The result is low intensity of competition, which allows firms to levy high markups on domestic sales and provides them with little incentive to engage in the restructuring and reorganization. The gains from simplifying entry regulations are substantial. According to an estimate based on the sample of 75 countries, were Egypt to reduce the number of procedures from 15 to 13 (as in Tunisia), industry markups would be reduced by 18 percent thanks to the growth in intensity of domestic competition.[41] Their reduction to 11 (as in Korea) would further lower markups by 38 percent.

Financial System

3.49. Egypt has made good progress over the last several years in improving and expanding the boundaries of its financial system, but the banking system continues to dominate, particularly in terms of financial intermediation for small savers and borrowers. The majority of commercial bank assets, loans, and deposits continues to be under the control of the Government. The state-owned banks do not provide lending to most private-sector businesses, nor is it clear that their risk management practices could support an expansion of lending.

3.50. Most domestic businesses are similarly unable to access funds from the private and joint-venture banks. The domestic private banks, which are considerably smaller than the state-owned banks, are located primarily in or near Cairo and Alexandria. The joint-venture banks, similarly located, focus mainly on serving large corporations. SMEs, while representing over 98 percent of all firms, account for only 5-6 percent of total loans extended. In effect, a tremendously large percentage of private-sector businesses rely on retained earnings from operations, delaying or even preventing investment. Banks' reluctance to lend reflects several issues, particularly continued lack of effective lender protection in the event of non-repayment and low levels of financial disclosure on the part of borrowers. In addition, real lending rates remain high (as much as 10 percent), discouraging legitimate borrowers.

3.51. The GOE should consider measures to attract more foreign investment to the financial sector. The experience of transition economies demonstrates that successful bank restructuring requires banking privatization to strategic investors that are sound, reputable foreign banks. Foreign ownership insulates the banks from pressures from the government or the enterprise sector to extend credit to failing enterprises.

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[40] S. Djankov, R. La Porta, Lopez-de-Silanes, A. Shleifer (2000), "The Regulation of Entry," *NBER Working Paper 7892*, National Bureau of Economic Research, Cambridge, Mass., September.

[41] See B. Hoekman, H. L. Kee and M. Olarreaga. 2001, "Markups under domestic and foreign entry", background paper for the World Development Report 2001, The World Bank, Washington, D.C.

3.52. International experience indicates that expanding financial intermediation in systems dominated by weak and inefficient state-owned banks requires wholesale restructuring, including majority sale and management transfer to the private sector of state banks. While such widespread reforms are being undertaken, the most important reforms to be pursued include: (i) continuing improvements in the accounting, auditing, and disclosure practices of banks and businesses, in order to provide a foundation for lending once there is greater competition in the system; (ii) improving the enforcement of creditor rights, particularly the perfectibility of collateral of borrowers in default; and (iii) investigating the possibility of developing alternative loan security arrangements.

Corporate Tax

3.53. The corporate tax system in Egypt lends itself to interpretation due to the lack of standard accounting practices and disclosure of information requirements for businesses. As in other countries, incentives exist in the system that encourage businesses to under-report their revenues and profits and for tax officials to over estimate the amount owed to the Government. Due to the lack of explicit guidelines and the presence of benefits that can be reaped by both sides, negotiation on the actual tax payment occurs. Thus, it is not surprising that Egyptian businesses report that: (i) tax and tax regulations are considered the most important constraint; (ii) tax evasion through informal payments to officials is not uncommon; and (iii) evasion of taxes and duties result in unfair advantage to some firms.

3.54. An additional feature of Egypt's tax system is the prevalence of tax holidays and other types of tax relief given to sectors or activities the Government sees as priority areas, for example, exports or investments in the new areas of land development (e.g., New Valley). Though the effectiveness of these holiday schemes appear to be limited, businesses recently surveyed appear to approve of the scheme because of the distance it gives them from the tax authorities for a period of time. The tax relief provided to exporters is in the form of duty drawbacks and sales tax rebate on imports. However, the procedures to obtain this relief are complex, and few of the smaller firms benefit from these schemes.

3.55. The corporate tax system is under review (see Chapter IV) and reforms expected to be introduced will simplify the system and improve the effectiveness of tax collection. Tax collection can also be increased by setting performance standards for tax officers. Clarity and transparency in the performance criteria (such as processing time) accompanied by a good management information system for monitoring the accomplishments should help in making the corporate tax system quicker and more predictable for businesses.

Commercial Legal System

3.56. While the judgments made through the commercial court system appear to be well respected by the Egyptian private sector, the system is viewed as being slow in resolving commercial legal disputes, thereby reducing its overall effectiveness. The relatively few judges, poor remuneration, widespread use of "court experts" (civil servants without law degrees), poor court facilities, and cumbersome procedures all contribute to a clearance rate (the percentage of filed cases that are actually resolved) of only 36 percent.[42] Cases that are cleared take an average of six years to be resolved. Such delays reduce the private sector's ability to fully rely on contractual business arrangements or on formal legal resolution in the event of a dispute, increasing

[42] Data from the mid-1990s. Clearance rates in most developed countries range between 80 and 100 percent.

the need to rely on established business contacts and other "insiders", and raising the cost of business transactions.

3.57. Judicial improvements to increase the speed and capacity of the commercial courts will take time, but are necessary to support the further development of a market economy. As a first step, a focused investigation of the source of delays in commercial dispute resolution should be undertaken by a panel of judges, lawyers, businesses, and justice officials. The panel would (i) identify areas that are particularly prone to delay, changes to reduce those delays, and performance indicators[43] for the system, and (ii) establish a baseline and future goals.

3.58. Pilot improvement programs for the commercial courts could be pursued to evaluate the improvements to case resolution and to private sector usage of the system. Pilot courts within the major business centers could incorporate some of the key elements of improvement, including: specialized recruitment and increases in the number of judges, specialization of some judges in key areas of dispute resolution (e.g., bankruptcy, contracts, taxes), strengthened administrative and case management practices, and upgraded facilities and equipment. In addition, expansion of alternative dispute resolution mechanisms or the introduction of additional mechanisms such as small claims courts could help to reduce the enormous backlog of cases now burdening the court system.

III.4. Conclusion

3.59. The over-protection and over-regulation of private economic activity have three implications. *First*, Egyptian consumers pay higher prices for most tradeables than world prices, indicating that Egyptian firms have high mark-ups which they can maintain due to low competition.[44] This raises the cost of living for the population, including low income groups who can ill afford even a small price differential between Egyptian and foreign goods. *Second*, Egyptian firms are not being prepared to compete in the highly competitive international markets because they have limited competition at home. *Third*, the business and trade regime do not provide any incentives to domestic firms to invest resources in export expansion.

3.60. In addition to the impact on domestic consumers and producers, the business environment and trade regime do not create a climate favorable to attracting foreign firms, especially those seeking to exploit a cost advantage. The preferred mode of corporate structure for foreign firms establishing a presence in a foreign country is generally as a wholly-owned subsidiary. In particular, firms investing heavily in technology – i.e., those that will contribute significantly to upgrading of labor skills – tend to establish wholly-owned subsidiaries. These types of firms will not enter if they perceive the local business climate as unfavorable to private business activity. Consequently, technology-intensive and export-oriented foreign firms are not likely to invest in Egypt as long as there is no significant improvement in governance.

IV. Regional Integration: Access to Quad Markets and FTAs

3.61. Bilateral liberalization has been the major trait of Egypt's foreign trade policy since the mid-1990s. The recently initialed Association Agreement with the EU, Egypt's largest trading

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[43] E.g., filed cases per judge; cases resolved per judge; clearance rate; caseload per judge; time to resolve a case; cost per case; etc.

[44] See S. Fawzi (2000), "Institutional Barriers to Egyptian Exports," in H. Nassar and A. Aziz, eds. *Egyptian Exports and Challenges of the 21st Century* Center for Economic and Financial Research and Studies, Cairo, Egypt, 2000 (p. 51).

partner, provides a strong rationale for this policy. However, significant benefits from regional liberalization are not likely to materialize unless accompanied by multilateral liberalization, including services. For example, the latter, however, can be linked with negotiating better access to "Quad" markets – Canada, the European Union, Japan, and the United States – for sensitive products. Benefits will be twofold: Egypt will benefit from efficiency gains from its own liberalization as well as from increased exports of sensitive products to Quad economies.

IV.1. Improving Access to Quad Markets

3.62. The best opportunities in the medium-term for Egypt's exports lie in the Quad markets. In spite of the tariff preferences granted by the Quad countries under different Generalized System of Preference regimes, Egyptian exports still face tariff peaks with rates above 15 percent for a significant number of both agricultural and manufactured products. Tariff peaks faced by Egyptian exporters in the Quad markets vary from country to country in terms of their product coverage. In the European Union and Japan most of the tariff peaks occur in agricultural products, whereas apparel faces major barriers in access to the U.S. and Canadian markets. Egypt seems to be competitive in a large number of "Quad-peak" tariff products.

3.63. If Egypt had duty-free access in Quad-peak tariff items, the value of Egypt's exports would increase by around $350 million on an annual basis, and total exports would increase by 10 percent (see Table III.5).[45] The change in exports triggered by the elimination of "peak" tariffs would vary considerably across Quad markets. The largest potential for growth is in exports to Canada. The potential is also large for an increase in exports to the U.S., and rather negligible for exports to apparently much less restrictive EU markets for Egyptian 'peak' tariff products. Although the potential for the increase in Egypt's exports of these products to Japan is almost negligible in relation to Egypt's total exports, the increase in these exports would raise the value of Egypt's total Japan-oriented exports by 38 percent.

Table III.5
The impact of "zeroing" peak tariff rates on Egypt's exports
(total over 1996-98, in million of US dollars and percent)

	E.U.	U.S.	Canada	Japan	Quad
Number of "peak" products	179	257	605	164	825
Agricultural "peak" products	84	21	11	35	10
Manufactured "peak" products	0	85	251	4	250
All "peak" products	84	106	262	39	351
Memorandum:					
Change in total exports to Quad (in percent)	3	15	1379	38	10

Source: World Bank staff calculations based on data from UN COMTRADE database as reported by Quad countries.

3.64. There are two complementary channels through which Egypt can reduce tariff peaks in the Quad: by future bilateral negotiations within the Euro-Mediterranean framework and by future WTO negotiations to reduce tariff peaks in other Quad members. A possible strategy for

[45] A simple partial equilibrium model has been used to calculate the export effects of the removal of tariff preference for Egypt as well as for other developing countries. The peak rates are "zero-ed" at the 2-digit level of the Harmonized System in Quad markets on Egypt's exports. For more details, see B. Hoekman, F. Ng, and M. Olarreaga (2000), "Tariff Peaks in the Quad and Developing Countries Exports", Development Research Group, The World Bank, Washington, D.C.

Egypt is to offer liberalization of Egyptian services markets in exchange for market access concessions on trade in sensitive goods in Quad countries. Telecoms and financial services are among the candidate sectors in which Egypt could grant better access to Quad countries. This would also generate further gains by improving the efficiency and quality of these services in Egypt. Thus, Egypt would not only gain from concession granted by Quad countries, but also from its own concessions.

IV.2. Free Trade Agreements

3.65. Bilateral and regional free trade agreements (FTAs) have become a major feature of Egyptian foreign trade policy since the mid-1990s. Considering the size of the EU, the recently initialed Association Agreement overshadows all other FTAs in terms of importance for Egypt. These types of agreements can unintentionally complicate the trade regime of a country, especially if the various FTAs adopt different tariff structures and agreements on negative and positive lists for exports. Furthermore, ambiguities can arise with the trading relationship with other signatories of an FTA especially on rules of origin issues. For example, in the case of the Association Agreement, will Egypt have free trade with Morocco and Tunisia, who have already signed the agreement? Also, all FTAs contain multiple exemptions to duty-free access and includes different provisions concerning the rules of origin, further undermining their real significance.

3.66. Hence, it may be advisable to undertake a detailed review of all FTAs in order to search for ways to maximize Egypt's benefits from these agreements, especially in the context of the expected adoption of the Euro-Mediterranean Agreements. FTAs should be assessed from the point of view of the extent to which they represent a stepping stone to global integration of the Egyptian economy. Another problem related to bilateral FTAs is the choice of a partner. While there are reasons to believe that an FTA with the U.S. would be a source of significant gains to Egypt, one may consider extending negotiations to other U.S. partners in NAFTA – mainly Canada. Our analysis suggests that short-term gains from duty-free access to Canada would be larger than to U.S. markets.

Chapter IV

Towards a More Result Oriented Budget Process

I. Introduction

4.1. The Government of Egypt (GOE) has resources equivalent to about 27 percent of GDP at its disposal which can be used to improve the quality of life of its citizens through the financing of essential services and to reduce the level of poverty. In addition, the Government sets policies and regulations that affect the functioning of markets and the enforcement of the rule of law, impact on income distribution by raising revenues that themselves have a distortionary impact upon the economy.

4.2. Questions of effectiveness and efficiency are increasingly being raised both by civil society and government officials: have budget expenditures resulted in the provision of adequate services to the public and has this been done at least cost? In order to provide a substantive answer to this question, a public expenditure review would be needed. However, even prior to analyzing public expenditures, an analysis of whether the budget is flexible enough to allow the implementation of policies in a manner which yields the desired results in terms of quality, population coverage, and cost is useful.

4.3. The chapter presents suggestions towards making the budget process in Egypt more results-oriented or "performance based". This report does not advocate that Egypt adopt the advanced public sector management systems of countries such as New Zealand or Australia. Rather, since the Government of Egypt has already shown interest in moving towards getting better outcomes from its expenditures and, in particular, has an interest in the concept of performance management, this chapter provides information on the steps involved in moving closer to this ideal.

4.4. This first section of this chapter provides a general overview of the budgetary processes which support the delivery of the essential services. It also provides suggestions on how these processes could be improved in order to enhance the effectiveness of budget expenditures. The next section provides an overview of public expenditures and financing. The third section discusses the budgetary processes and the extent of transparency, comprehensiveness, and efficiency. The last section discusses steps that could be taken to move from input-oriented management to results-oriented management in order to improve the impact of government expenditures on the population.

4.5. The main messages of this chapter are:

- The efficiency and effectiveness of public expenditures could be improved by making expenditure priorities explicit and enhancing the transparency and comprehensiveness of the budget.
- Egypt's current budget process could take steps that would improve its result orientation. The current system makes it difficult for the Government to implement its policies and to assess the outcome of its expenditures.

- Effective service delivery is constrained by the civil service pay and personnel management system. Reform of the civil service is unavoidable if the Government wishes to achieve efficiency gains within the budget.

II. Overview of Public Expenditures and Financing

4.6. Total expenditures in Egypt are 27 percent of GDP, compared to 16 percent of GDP for lower middle income countries. The recurrent and capital expenditures are 20.2 percent and 6.8 percent of GDP respectively (see Table IV.1). The trend exhibited in public expenditures as a share of GDP in the latter half of the 1990s is that recurrent expenditures are contracting gradually while public investment appears to be on the upswing.[46] The GOE was successful in reducing recurrent expenditures, yet its beneficial effect on the overall deficit was countered by a drop in fiscal revenue by approximately the same amount. The poor revenue performance can largely be attributed to a reduction in non-tax revenues, specifically the transfers received from the Suez Canal Authority and the Egyptian General Petroleum Company. Consequently, the fiscal balance was in significant deficit in 2000, at 3.6 percent of GDP.

Table IV.1.
Summary of Fiscal Operations, 1996-1999
(in percent of GDP)

	1996	1997	1998	1999	2000(e)
Total Revenue	26.5	25.1	24.2	24.2	24.3
Total Expenditure	27.8	26.0	25.3	30.1	28.0
Recurrent Expenditure	22.6	20.8	19.9	20.2	21.0
Interest Payments	7.0	6.0	5.3	5.4	5.2
Investment Expenditure	5.2	5.2	5.4	8.2	7.1
Lending by NIB	..	..	..	1.7	..
Primary Balance	5.7	5.1	4.2	-0.5	1.5
Overall Balance	-1.3	-0.9	-1.1	-4.2	-3.6
Financing	1.3	0.9	1.0	5.9	3.8
External	-0.6	-0.6	-0.5	-0.6	-0.5
Internal	1.9	1.5	1.5	6.5	4.3
Privatization	0.0	0.0	0.7	0.3	0.6

Source: Ministry of Finance

4.7. The remainder of this section provides a brief overview of the recurrent expenditure program classified into economic and functional classifications and investments. The discussion of financing of expenditures primarily covers aspects of the taxation system.

II.1. The Expenditure Program

4.8. The allocation of public expenditures among various functions is presented in Table IV.2. The majority of these expenditures fall under the central government, with the rest distributed between public service authorities and local government. The two largest categories of expendi-

[46] Barring significant revision of the fiscal accounts for FY1996-FY1998.

tures, which consume over half of the recurrent budget, are social sector expenditures and interest payments on the public debt. General services and defense consume 18 percent and 13 percent of the recurrent budget respectively. Economic services, which include agriculture, transportation, and irrigation, are less than 2 percent of the recurrent budget. In terms of trends in the recurrent budget, the two most striking aspects are the slight increase in social expenditures as a share of GDP indicating that they were protected from cutbacks as the recurrent budget contracted. The second aspect is that interest payments as a share of GDP have fallen over time.

Table IV.2
Recurrent Expenditure Composition

	1996	1997	1998	1999
Economic classification				
Wages and Salaries	6.1	6	6.1	6.5
Contr. to pension funds	1.9	1.7	1.7	1.8
Interest on debt	7	6	5.3	5.4
Internal	5.3	4.8	4.4	4.7
External	1.7	1.2	1	0.8
Material and supplies	1.4	1.4	1.3	1.2
Subsidies and transfers	1.9	1.6	1.5	1.5
Other	4.3	4.1	4	3.8
TOTAL	22.6	20.8	19.9	20.2
Functional Classification				
Central Government	20.2	18.4	17.5	17.7
General Services	4.0	3.6	3.2	3.6
Defense	3.0	2.9	2.8	2.7
Social Spending	5.5	5.4	5.6	5.6
Education	2.6	2.7	3.1	3.2
Health	0.6	0.6	0.5	0.6
Community and Social Services	0.2	0.3	0.3	0.2
Subsidies	1.9	1.6	1.5	1.5
Social Fund	0.2	0.3	0.2	0.2
Economic Services	0.6	0.5	0.5	0.5
Agriculture	0.3	0.3	0.3	0.3
Irrigation	0.2	0.2	0.2	0.2
Transport and Communication	0.0	0.0	0.0	0.0
Interest payments	7.0	6.0	5.3	5.4
Local Government	0.9	0.9	0.8	0.9
Public service authorities	1.5	1.5	1.5	1.6
TOTAL	22.6	20.8	19.9	20.2

Source: Ministry of Finance

4.9. An alternative way of viewing the recurrent budget is to break it down by economic classification: wages, materials, subsidies, pension fund contributions, and interest payments on the public debt. The two largest components of the budget are wages and interest payments, respectively 6.5 percent and 5.4 percent of GDP. Not only have wages and salaries increased their share of GDP, but they also increased from 27 percent to 32 percent of the recurrent budget during 1996-1999. In the absence of careful analysis of both the compensation package offered to civil servants and the staffing levels – which most observers judge excessive – it is difficult to evaluate the desirability of this development, which must be seen on the context of an overall vision of the

civil service's role in moving towards a results oriented budget. Materials and supplies consume a slightly smaller share of GDP than a few years ago but have their share in the recurrent budget has been steady. Finally, subsidies payments, which are mostly on imported food items, account for a relatively modest amount. However, if the currency depreciates, subsidy payments could increase significantly.

Table IV.3
Comparative Table for Social and Infrastructure Indicators

Country Name	Freshwater resources (m^3 per capita)	Roads, paved (% of total)	Telephone mainlines (per 1000 people)	Electric power consumption (kwh per capita)	Under-5 mortality (per 1000 live births)	Illiteracy Rate (% of people 15+)
Egypt	966	78	60	803	59	45
Middle East & North Africa	1,045	50	82	1,162	55	36
				357		
Low income	6,756	19	23	1,340	107	39
Middle income	9,333	50	109		38	15
Lower middle income	6,227	50	90	1,042	39	16
Upper middle income	...	47	176	2,435	35	10
World	8,354	43	146	2,053	75	24

Source: WDI
All data fro 1998, except electric power consumption is 1997 and roads paved is for 1996.
Data for illiteracy rates are for 1999.

4.10. Investment spending is estimated at 8.4 percent and 6.8 percent of GDP in 1999 and 2000 respectively. The substantial decline in investment spending helped to reign in the fiscal deficit. Disaggregated data on investment by sector show that the two largest budgetary allocations are given to agriculture and housing. The 2.8 percent of GDP increase recorded in 1999 is largely due to a more comprehensive recording of investment expenditures (especially in agriculture, transportation, and electricity), which are likely to be related to spending on the mega projects, including a large pumping station.

4.11. An international comparison of some basic social and infrastructure indicators shows that Egypt appears to lag behind in water resources, health, education, electric power, and telecommunications compared to other lower middle income countries (see Table IV.3). However, it does not necessarily follow that an increase in public expenditures to these sub-sectors is the solution since the appropriate response may be to improve regulations to encourage the provision of these services by the private sector or to improve the performance of existing public sector providers. Thus, in order to reach meaningful conclusions as to the appropriateness of the budgetary allocations, a public expenditure review which addresses issues of a supply gap in service delivery, appropriate private/public provision and policy mix, and the efficiency and effectiveness of expenditures should be undertaken.

II.2. Financing of the Expenditure Program[47]

4.12. The Government finances its expenditures through tax revenues, transfers, foreign assistance and borrowing. Revenues covered 87 percent of total expenditures and the remainder was borrowed domestically. Tax revenues financed over half of expenditures in FY2000, while non-tax revenue – largely transfers of profits from the Petroleum Company, the Suez Canal Authority, and the Central Bank – covered another 21 percent. The remainder of government revenue is composed of contributions from local sources and cost recovery proceeds. The fiscal deficit has been financed fully from domestic resources since FY1995; net external financing has been negative. Equal amounts of financing were provided by the banking and the non-banking sectors. The National Investment Bank provided financing of 6.4 percent of GDP by drawing on the surpluses of the social security system and by issuing investment certificates to the public. In addition, smaller amounts of privatization proceeds accrued to the treasury.

4.13. Further development of Egypt's tax system will be critical to future financing of government expenditures, especially given the downward trend in the transfer of profits and the eventual decline in customs duties. Table IV.4 compares the tax structure in Egypt with that of countries in the Middle East and OECD and suggests that the tax structure in Egypt broadly mirrors that of other countries in the Middle East. However, compared with the tax structure of OECD countries, the Egyptian tax system raises only half as much as a share of GDP. It relies heavily on customs duties and general sales taxes and relatively little on personal income taxes. Opening the economy to rest of the world will lower the revenue contribution from import taxes and does highlight the need to revisit the overall taxation package.

4.14. The Egyptian authorities recognize that the present taxation system is the result of partial reform initiatives over the years whose main objectives were to raise larger revenues. These reforms also responded to demands from the investment community to provide investment incentives. As a result, the tax system often distorts economic incentives, is complicated to administer, and raises insufficient amounts of revenue.[48] Its impact on improving investment incentives is also being questioned. The authorities are recognizing the present tax system's shortcomings and are identifying a tax reform program that could be initiated within the next several months based upon background studies and administrative preparations already underway. If implemented, these reforms would provide a more transparent and efficient incentive structure and broaden the tax base, and as such align the tax structure with that prevailing in other middle-income countries. The main reform measures under discussion include:

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[47] Because the revision of the fiscal accounts, which fully covered the spending and financing of the investment budget for FY1999, was not yet completed for the earlier years, this section will discuss the financing of the expenditure program only for FY1999. While the situation in other years may not correspond in all the details to that of FY1999, the general pattern is representative.

[48] World Bank (1995), *Egypt into the Next Century*, Discussion Papers, Vol. 1, May. Gannat El Samalouty (1999), *Corporate Tax and Investment Decisions in Egypt*, ECES, Working Paper Series, nr.35, February 1999, Cairo. Hanaa Kheir-El-Din, Samiha Fawzy and Amal Rafaat (2000), *Marginal Effective Tax Rates and Investment Decisions in Egypt*, ECES. Working Paper, no. 45, Cairo.

Table IV.4.
Comparison of Egypt's tax structure with that of middle income countries
(in % of GDP)

	Egypt FY1999	Middle Eastern Countries 2/	OECD Countries 2/
Corporate income tax	2.3 1/	2.5	2.4
Personal income tax	0.8	0.3	7.4
General sales tax	3.3	0.2	5.8
Excise tax	1.4	1.4	3.0
Customs duties	3.3	3.1	1.2
Other	4.5	2.5	9.7
TOTAL	15.6	10.0	29.5

Source: Government of Egypt and World Bank.
1/ Excludes Petroleum Corporation, Suez Canal and Central Bank
2/ 1990-1996

- Modification of the **corporate income tax** by (i) unifying tax rates by replacing the general rate of 40 percent and special rate of 32 percent applied to industrial and export entities; and (ii) reducing the prevalence of tax holidays and special tax regimes because of their cost in terms of loss in fiscal revenue (about 1.5 percent of GDP), their differential impact on sectors of the economy and modes of financing, and their perceived limited effectiveness.[49] One reform under consideration is not to renew tax holidays but to build investment incentives into the Tax Code. This will be more transparent, non-discriminatory, more predictable for the investor, and easier to administer.
- Simplifying the **personal income tax** system by (i) instituting a global income tax to replace the schedular income tax system (i.e., different rates on each source of income); and (ii) simplifying the family allowances and other income deductions by replacing it with a dual rate structure (15 percent and 25 percent). While the main goal of this reform is to improve the equity of income taxes, better administration could broaden the tax base and yield substantial additional revenues.
- Replace the **general sales tax** (GST) with a single rate value added tax (VAT) applied at the manufacturing, wholesale, and retail sales levels. The positive aspects of the reform include (i) increase the number of taxpayers from the present 60,000 up to 300,000;[50] (ii) unify the five GST rates into one rate; (iii) treat producers for the domestic and external markets equally by giving a full credit of VAT paid at earlier stages of production and by zero rating exports would assist exporters; and (iv) increase tax revenues by 2 percentage points of GDP. A review of the GST on excisable commodities is at present not on the agenda, but it is recommended that the present discrimination against imports be eliminated.

[49] Recent studies on marginal effective tax rates have shown that many tax incentives provide only negligible benefits to the investor.

[50] Without proper preparation, such an increase in the number of taxpayers could strain the administrative capacities of the GST administration .

III. The Budgetary Process

4.15. The budget is a key instrument that enables the Government to provide Egypt's population with services that the private sector does not provide (public goods) or does not provide in politically satisfactory amounts (merit goods). Poverty alleviation and providing an enabling environment for operation of the private sector are major objectives of expenditures policies, as expressed in official announcements of the GOE. It is therefore vital that the budgetary process be geared towards the effective and efficient delivery of services. Experience has also shown that budget policies tend to be most efficient when transacted in a transparent manner, which implies that they are recorded in a comprehensive manner.

4.16. To address these issues, this section will first describe the budgetary process as it functions today, and provide some suggestions on how this process may be improved. The key players in the budgetary process include (i) the Prime Minster's Office, in charge of overall economic development and setting sector priorities and the accompanying budget allocation; (ii) Ministry of Planning (MOP), which prepares the investment budget; (iii) the Ministry of Finance (MOF), which is responsible for the preparation and implementation of fiscal and budget policies; and (iv) the line ministries, which are responsible for implementing sector policies with the resources allocated to them.

III.1. Description of the Budgetary Process

4.17. The budget process has five main stages. The first stage is the negotiation stage at the working level among the Governorates, line ministries, and the MOF, which is completed by end-December. Stage two is at the Cabinet level; a draft consolidated budget is submitted to the People's Assembly by end-April. The third stage involves discussions, modification, and final approval by the People's Assembly, which takes place prior to end-June. The fourth stage is the disbursement, implementation, and monitoring of the budget, which occurs over the course of the fiscal year. The fifth stage is a review of the execution of the budget by the Central Audit Organization. The first three stages comprise the budget preparation and take about nine months to complete. The fiscal year goes from July 1 to June 30th of the following year.

4.18. The expenditure part of the budget is divided into four sections called "Chapters". The first two chapters comprise the recurrent budget. Chapter 1 covers wages and salaries, which include not only the base wage, but also an array of allowances. Chapter 2 covers materials and supplies and include all non-wage costs such as utility payments and paper supplies. Chapter 3 covers investment expenditures, and Chapter 4 covers debt service payments.

4.19. ***Stage One.*** The budget process begins in late-September or early-October when the MOF issues a Budget Circular to all government spending agencies (i.e., ministries, economic authorities, and local authorities). Though the Circular provides detailed instructions on the recurrent budget preparation, it does not provide budget envelopes or ceilings. At the first stage of the process, Governorates prepare by end-December their budgets, which include the expenditures of the line ministries operating on their territories and governorate-level services. The former category of expenditures are based upon proposals made by line ministry representatives in the Goverorates who coordinate their budget submission with their respective central ministries. The Governorates negotiate their budget proposal with the MOF in the presence of the line

ministry representatives. Once these negotiations with each of the Governorates[51] are completed, the line ministries prepare their overall consolidated budget.

4.20. The process for preparing the investment budget ("Chapter 3") is different from that of the recurrent budget. The proposals of the line ministries are reviewed by the Ministry of Planning (MOP) and by the National Investment Bank (NIB), which acts as the executing agency for the MOP. The MOP also initiates a number of projects on its own and is broadly guided in this process by the Five-Year Plan. Though the MOF's role in the preparation of the investment budget is mostly that of an observer, its representative sits on the board of the NIB.

4.21. ***Stage Two.*** The projections for the four budget chapters are consolidated into one document by the MOF and the budget proposal is shared with the Economic Ministers Group, composed of the Ministers of Finance, Planning, and Economy, the Governor of the Central Bank of Egypt, as well as several other key ministers. At this stage, the Group attempts to resolve any inter-ministerial conflicts. The President is actively involved and exercises decisive influence in this process. The result of this arbitration process is presented to the full Cabinet for approval. Adjustments are incorporated by the MOF and the revised budget is sent to the President for final adjustment and approval. Before end-April, the budget proposal is submitted to the People's Assembly, and the Minister of Finance makes a statement explaining its rationale and objectives.

4.22. ***Stage Three.*** At the People's Assembly, the budget is scrutinized by the Committee for Planning and Budgeting and specialized line committees. The Committee also discusses the overall budgets of the Governorates. All the proposed amendments from Assembly members must be channeled through these committees, and their approval requires the consent of the MOF and the line ministries. After this review, as specified in the Constitution, the draft budget is submitted for a vote to the Assembly to approve or reject the budget. Prior to the vote, parliamentarians subject the Minister of Finance and the line ministries to intense questioning. The budget is finalized by end-June, although in case of a delay, the monthly allocations of the previous year's budget are renewed on an interim basis.

4.23. ***Stage Four.*** Once approved, the budget execution is monitored and supervised by the MOF for all non-investment expenditures, and by the MOP and NIB for the investment expenditures. The MOF exerts *ex ante* control on all expenditures through its Financial Controllers, who are present in all spending agencies.

4.24. ***Stage Five.*** The Central Accounting Office (CAO) – who in recent years has been brought under the authority of the President rather than the People's Assembly – is responsible for the *ex post* review of the final budget accounts and reports its findings to the People's Assembly. The process of reviewing the accounts and finalizing the expenditure estimates begins immediately upon the completion of the fiscal year in June. Before December, the line ministries forward their accounts to the MOF for discussion and finalization by end-February or early-March. The CAO audits these statements and is involved in their discussions with the MOF and prepares its own final report. By end-March the official final accounts are sent by the MOF to the People's Assembly together with the final report of the CAO which is discussed at the People's Assembly. Its findings appear to focus primarily on accounting irregularities of Economic Authorities resulting from such measures as depreciation rules, the calculation of reserves, and the proper level of inventories.

[51] There are 26 Governorates. The city of Luxor receives its own budget.

4.25. Though the budget process appears highly structured, in recent years budgets have been revised mid-year and expenditure programs reduced. The revision of the budget occurs due to revenue shortfalls as well as additional spending that is identified during the course of the year. Therefore, revenue projections and overall budget deficit targets that determine the *ex ante* expenditure envelope considered in Government deliberations no longer act as a hard budget constraint. Data suggest that investment expenditures in recent years ran ahead of their budget projections and led to mid-year budget revisions. For instance, in FY1997 and FY1998 the actual investment budget expenditures exceeded the planned budget by an average of about 65 percent, or in excess of 2 percent of GDP.[52]

III.2. Main Issues

4.26. The budget is a key instrument in allowing the Government to implement its policies. However, at present the budget process itself creates obstacles that inhibit changes the Government desires to introduce. The present budgetary process focuses excessively on managing financial flows, rather than on attempting to build a process which ensures the adoption of expenditure patterns that implement government policies or on achieving the best possible results within the budget allocation. Specifically, the present budget process discourages (i) prioritization of the expenditures; (ii) achieving cost savings in service delivery; (iii) transparency; (iv) comprehensiveness; and (v) results orientation. This section discusses why these results occur and what could be done to improve upon the situation.

Prioritization of Expenditures

4.27. Prioritization of expenditures means that programs which should be given precedence in terms of funding are identified. At present, two aspects of the budget process inhibit this from occurring. First, the Budget Circular does not provide budget envelopes or ceilings that would encourage line ministries to better identify their priorities. Under best practice such envelopes result from tradeoffs approved at the Cabinet level in the context of an agreed upon medium-term macro economic framework. The failure to provide for a budget envelope leads line ministries to prepare unconstrained budgets based upon perceived needs, with budget demands far exceeding the previous year's allocations. At this stage, the process undermines prioritization. Table IV.5 provides an illustration for the Ministry of Health and Population (MOHP), where the approved budget for FY2000 was about one third of the requested budget.[53]

4.28. The second feature of the budget process which dissuades prioritization is significant revision of expenditures during the implementation year due to continuous *ad hoc* budget negotiations. This undermines the budget priorities established by all players including the People's Assembly, the Governorates, the line ministries, and even the Cabinet. Political pressures placed on the Government result in these revisions. For example, pressure can be placed on expediting the completion of investment projects, initiating projects not included in the approved budget, or hiring graduates *en masse* to reduce the short-term unemployment rate.

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[52] These are years before the recent revision of investment expenditure data and therefore may even under represent the extent of revision that occurred.

[53] Data obtained on the budget proposals by the education sector in a particular Governorate show similar pattern of unconstrained requests.

Efficiency Gains in Service Delivery

4.29. Efficiency in service delivery can be improved if spending agencies are given the authority and encouraged to adopt a less expensive way of providing services assuming that activities are not under-funded. As mentioned above, the negotiations between line ministries and the MOF are distorted by the lack of budget envelopes, which leads to extravagant spending proposals made by the line ministries in the first phase of the budget process. Consequently, negotiations focus on reducing budget requests rather than ensuring that resources are used efficiently. Moreover, the budget process does not contain rewards for efficient service delivery, such as greater flexibility in resource use that other countries incorporate in their incentive systems.

4.30. It should be noted that even if the line ministries find ways to deliver services more efficiently, the lack of flexibility in the budget discourages such changes. First, ministries are in fact asked to extrapolate their previous level of expenditures and make marginal adjustments for new initiatives. This process leaves little scope for ministries to search for least-cost options and to set their programs based on long-term total cost effectiveness, taking into account all opportunity costs for the resources made available to them. Second, in order to achieve efficiency gains, resources (including staff) may need to be re-deployed, which may be difficult to implement. For example, if nurses can deliver some services as effectively yet less expensively than doctors, the line ministry may have difficulty shifting the doctors.

Transparency

4.31. Transparency of the budget is essential for ensuring accountability to the legislature and to Egyptian citizens. In order to achieve a reasonable level of transparency, objectives should be clearly defined, expenditure allocations made explicit, and monitorable indicators included. Upon completion of the execution of the budget, actual expenditure amounts should be disseminated and information provided on whether the objectives were achieved based upon an assessment of the indicators. Progress towards budget transparency could begin by better sharing information regarding the financial allocations approved and spent in the budget and should gradually move towards issues related to effectiveness (what is being achieved) and efficiency (was this achieved al least cost). Lack of budget transparency hampers both an informed public discussion on budget policy and oversight of the government's use of national resources. Guatemala provides an example of how a developing country has adopted a transparent mechanism to allow policy makers and civil society to monitor the financial aspects of the budget in a timely manner (see Box IV.1).

4.32. Budget transparency is limited in Egypt at all stages. Even upon the approval of the budget by the People's Assembly, it is not made available to the general public. Within the public sector, sections of the document are only available on a "need-to-know" basis. During the implementation phase, basic financial statistics are not disclosed, making it difficult to assess whether expenditures are in accordance with the approved budget. Upon completion of the fiscal year, actual expenditure data are made available in a very aggregated form and with great delay.

Table IV.5.
Ministry of Health and Population: Budgets FY1996-FY2001
(in LE million)

	FY1996	FY1997	FY1998	FY1999	FY2000	FY2001
Proposed budget						
Total	2,226	6,868	6,184	6,675	9,385	12,321
Wages and salaries	939	1,065	1,157	1,287	1,653	2,076
Supplies	976	1,796	2,520	3,383	5,152	7,608
Investment	300	4,000	2,500	2,000	2,575	2,586
Debt payments	12	8	6	5	5	5
Approved budget						
Total	n/a	n/a	n/a	n/a	3,538	3,962
Wages and salaries	n/a	n/a	n/a	n/a	1,341	1,662
Supplies	n/a	n/a	n/a	n/a	1,117	1,526
Investment	228	523	590	607	644	504
o/w locally financed	172	441	439	490	494	n/a
Increases to local Invest. Fin.	433	578	783	453	625	n/a
Total final budget for Invest.	661	1,101	1,373	1,060	1,269	n/a
Final Accounts						
Total	1,975	2,245	2,655	2,798	n/a	n/a
Wages and salaries	847	941	987	1,071	n/a	n/a
Supplies	492	524	621	799	n/a	n/a
Investment	624	772	1,041	923	n/a	n/a
Debt payments	12	8	6	5	n/a	n/a
		Final Account/Proposed (in percent)			Approved/proposed (in percent)	
TOTAL	89	33	43	42	38	32
Wages and salaries	90	88	85	83	81	80
Supplies	50	29	25	24	22	20
Investment	208	19	42	46	25	20
Debt payments	100	100	100	100	n/a	n/a

Source: Ministry of Health and Population

Box IV.1. Guatemalan Financial Management System

Main Achievements:

- Widespread reduction in prices paid for supplies (e.g., x-ray film down 60 percent and pharmaceuticals drastically reduced) due to modernized procurement and payment systems, which have substantially cut the time and procedural steps (and thus premiums built into prices to reflect inflation and/or bribes by suppliers to speed payments).
- Arrears to suppliers have been eliminated. Before, the so-called "floating debt" used to linger up to three months into the next fiscal year, preventing the "opening" of the new budget.
- Government financial transactions are entered only once into the national accounting system at the location where they originate and reported instantaneously through communication lines to the Ministry of Finance for consolidation. Once payments are authorized by line agencies, they are made by the Finance Ministry through the banking system, on average within 72 hours (compared to payment delays averaging from 3 to 6 months before).
- Electronic fund transfers have increased from near zero in 1996 to 50 percent of public sector payments in 1998, and are expected to cover all payments by mid-1999. This reduces the time and cost of transactions, discretion in payment priorities, and lost/stolen checks.
- The number of Government bank accounts has been reduced from 1,300 in 1996 to 600 in 1998, with the aim of keeping one single account by 2000.
- The number of budget line items was reduced from 7,920 to 887 during 1997-1999, permitting a greater focus on programs while providing executing agencies with increased flexibility to adjust their budgets without requiring time-consuming prior approval from the Finance Ministry.
- The unique relational database provides immediate and detailed information on all recorded financial transactions, individually or aggregated in a variety of ways (by supplier, authorizing official, region, product, budget classification or program, time period, cost levels, etc.). This provides an audit trail as well as relevant and timely budget execution information for managers at various levels.
- For the first time, the 1999 budget was presented to the Congress on CD ROM on September 2, 1998, along with actual 1998 expenditures current through August 28, 1998 (i.e., only four days old). This provides more manageable information for congressional deliberations and promotes a focus on results as opposed to future budget priorities.
- Legislators, private citizens, NGOs, and any other stakeholders can access proposed and executed national budgets at several computer sites in Guatemala and through the Internet.
- Physical as well as financial indicators are now included in the budget to better measure performance and promote a results-oriented focus, and line ministries have timely and accurate information to improve physical programming and service provision. The World Bank and Inter-American Development Bank teams implementing projects in the education and health sectors report dramatic improvements in project implementation due to the decentralization of financial management responsibilities, and the improvement in financial management policies and procedures and information availability.

4.33. However, since the budget does not convey information as to the objectives that are to be achieved, debate is restricted to how much is spent in broad public policy areas, absent consideration of efficiency and effectiveness. Finally, the CAO's audit reports are narrowly disseminated and do not seem to contain any consideration of effectiveness and efficiency of government expenditures.

Comprehensiveness

4.34. Comprehensiveness of the budget is a prerequisite for good fiscal policy management as well as for good coordination of the expenditure programs within line ministries. In Egypt the preparation and management of the budget could be significantly improved by giving the MOF responsibility for the preparation and the execution of both the recurrent and capital budgets whose responsibilities are currently divided between the MOF and MOP respectively. The present arrangements complicate the implementation of fiscal policy and has resulted in a softer budget constraint than would be the case if a single authority were to effectively manage the overall budget. This softness results mainly because changes that are instituted to the investment budget (such as the inclusion of the mega projects) can have large fiscal consequences. Also, this dual responsibility creates difficulties in making realistic budget projections for the investment needs of ongoing projects and for the recurrent cost implications of the investment program.

4.35. Including the following areas in the budget would enhance its comprehensiveness: (i) military expenditures financed by foreign resources; (ii) the butane subsidy (estimated at LE 1.5 billion) which is presently internalized by the Petroleum Company which reports transfers to the budget on a net basis; (iii) government arrears[54] which are poorly reflected in the recurrent budget; (iii) contingent liabilities, which refer to those expenditures that the Government may incur in case certain events occur (e.g., future pension liabilities, non-performing loans of the banking sector, and debt payments of public enterprises with weak balance sheets); and (iv) forgone tax revenues, which pertain to losses in revenue that result from the provision of tax holidays and incentives. In the absence of this information, it is difficult to judge whether tax regulations achieved their intended objectives. Such information could be either formally included in the budget and supported by relevant statistics or mentioned as areas that need to be considered for an assessment of the overall commitments of the government and may need to be analyzed carefully.

4.36. The budget document could increase its relevance for fiscal management by including information on future financial commitments, especially with respect to public investment. At present, the budget provides a snapshot of Government expenditures for one year. The inclusion of future financial commitments of the Government – such as the mega projects – would assist policy makers in framing their medium-term fiscal policy framework, thus contributing to prudent fiscal policy and rational resource allocation. This could be accomplished by publishing a multi-year investment program that provides not only the annual budget allocations, but also (i) information on financial commitments of the project's original total cost and the expected disbursement and their financing for the next several years; and (ii) the recurrent cost implications of investment projects. Though the investment budget is currently managed separately from the recurrent budget, line ministries could provide estimates of the recurrent cost implications and incorporate them into the projection of their own future budget requirements.

[54] Since the recurrent budget reports on a cash basis, arrears appear only implicitly and with a delay as a charge to be paid out of the next year's budget out of the MOF's contingency allocation. These arrears pertain mainly to unpaid bills owed to the major utilities. The investment budget is reported on an accrual basis, and no clear record exists of accrued arrears.

Results Orientation

4.37. The budget's format, preparation, and implementation focus on inputs rather than on outputs or outcomes,[55] with no explicit attempt to record the efficiency in service delivery. Since the budget document does not relate the authorized spending limits to the achievement of objectives and to well defined outcomes, the approval of the People's Assembly and the controls exercised by the MOF focus on purely financial aspects of the budget. Two characteristics of the budget process which make it difficult to determine whether results are achieved from public expenditures are (i) the level of aggregation in the budget, which makes it difficult to distinguish what uses the resources are being authorized for. For example, the consolidation of wages and salaries for the Ministry of Education prevents understanding whether the funds are spent on administrative staff or teachers; and (ii) the absence of monitorable objectives, which makes an appropriate expenditure tracking impossible. For example, setting objectives could track whether the vaccines purchased by the Government result in an increase in the number of children vaccinated.

4.38. The auditing system does not help in ascertaining whether the resources used led to the achievement of the desired results. Though the legislature has given the CAO the mandate to undertake performance audits, these are not performed on the budgetary account. There is some performance audit of the Economic Authorities (e.g., the utilities), but the findings are used to help calculate the necessary budget support for these entities. However, even if the CAO desired to carry out performance audits of government expenditures, the format of the budget and the subsequent reporting by the line ministries would prevent any meaningful performance audit.

IV. From Input to Outcome Management: Results Oriented Budgeting

4.39. The MOF's primary function is managing public finances to ensure fiscal stability while channeling resources to government agencies[56] to allow them to provide public services. This focus tends to overlook, the issues of whether the desired results were indeed achieved (i.e., effectiveness) and at least cost (i.e., efficiency). However, given the large development agenda remaining in Egypt, this approach may no longer suffice and much is to be gained by considering the issues of effectiveness and efficiency, certainly as overall funding for service delivery is not likely to increase substantially in the near term. Furthermore, examples exist within Egypt's expenditure program that suggest that better results in terms of effectiveness and efficiency could be obtained from the resources presently allocated to social services.

4.40. Even though the concepts of efficiency and effectiveness have the appeal of simplicity, their application to budget expenditures is not easy. This stems in part because public expenditures have several objectives, some of which are not explicit. Still, the advantage of analyzing public expenditures from the angle of effectiveness and efficiency is that it requires policy makers to be clear as to what these expenditures aim to achieve, to measure the impact of these expenditures, and to assess progress made. Furthermore, this focus on achieving results encourages them to seek out ways to attain their goals at least cost, to review alternative delivery mechanisms, and to try to establish an incentive framework to achieve the desired outcomes.

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[55] Output refers to the physical result, for example, the number of children vaccinated against polio. Outcome refers to the desired result, i.e., the decrease in polio incidents among children.

[56] This includes line ministries, authorities and other spending units (e.g., hospitals and universities) supported by the GOE.

4.41. The remainder of the chapter reviews the developments and potential opportunities in Egypt for results-oriented budgeting. The following sections discuss (i) government initiatives to improve effectiveness; (ii) steps to shift from input to output management; and (iii) implications for the civil service.

IV.1. Government Initiatives for Results Oriented Budgeting

4.42. Since the mid-1990's the GOE has expressed a desire to achieve better results from its budgetary resources and has adopted initiatives to enhance the efficiency of government expenditures. Recently the Minister of Finance has made public statements indicating that efforts towards a more results-oriented budget process were high on the ministry's agenda. Even the privatization program reflects this commitment to refocus GOE energies and resources on clearly specified public sector objectives. Initiatives underway show that Egypt has not remained isolated from international trends and has attempted to redefine the role of government and make its methods of intervention more efficient. Examples of steps taken by the Government are:

- The proposed establishment of a Fiscal Policy Decision Support Unit to build capacity in MOF to implement Egypt's National Strategy for Economic Development. The Unit aims at improving the effectiveness of public expenditures, drawing upon the experience gained by a team of senior MOF officials who visited Malaysia.
- The proposed corporatization of 62 (public) economic authorities such as the Rail Road Authority and the Electricity Authority to make them financially independent of the Government. At present the economic authorities receive about LE 3 billion in annual subsidies, in addition to having received approximately LE 280 billion in cumulative investments.
- A project undertaken with donor support to improve the performance of the civil service. The project led to the creation of "Higher Committee for Administrative Reform" as well as "Administrative Reform Units" in all ministries, but more importantly to a constituency for efficiency reforms.
- Provision of a public toll-free phone number and internet access which provide information on obtaining public services.[57] This is the first step towards improving the delivery of these services. Plans exist to launch selective e-government services within the next two years, which would offer a new opportunity to streamline the provision of these public sector services.
- Outsourcing by Ministry of Health and Population (MOHP) hospitals of non-essential services (e.g., food service and cleaning) in order to reduce costs and improve service.
- Initiating health reform by reducing MOHP's role in service delivery. Under this reform the Health Insurance Organization (HIO) would become responsible for the financing of health services, which would be provided on a competitive and contractual basis by facilities run by the MOHP, HIO, or the private sector. The MOHP would focus on the regulatory and oversight responsibilities of service delivery.

IV.2. Shifting from Input to Outcome Management

4.43. The budget process is presently one that allocates resources to various agencies to implement vaguely defined objectives. It could be transformed into one that is designed to achieve

[57] The toll free number is 131 and the internet access is www.hokoma.gov.eg. Information is available for 728 services.

clearly stated results and that sets in motion a process which encourages the adoption of higher standards in terms of effectiveness and efficiency. Implementing this transformation is a multi-year task that is carried out gradually. Even countries that have initiated such reforms many years ago are still refining their procedures of defining desired results and establishing monitoring mechanisms (e.g., New Zealand, Canada, and the U.K.). In Egypt this approach could be applied selectively to ministries and/or governorates where the demonstration effects for other government agencies would be useful.

4.44. If the Government decides that it would like to eventually adopt results-based management, then important but achievable steps can be taken at the cabinet level. Initially this would entail redefining the scope of outcomes the Government intends to achieve through its budget activities. Restricting this scope releases resources that would allow greater funding for activities that the Government intends to retain under its purview. The Government could begin by clearly defining what it would like to achieve through its budget-financed activities, as distinct from what can be achieved by setting a proper regulatory environment for the supply of services. The Government's privatization program and its intention to rely on the corporatization model for the Economic Entities, presently run as Government agencies, follows from such a reassessment.

4.45. Then, the Government would need to agree on the resources that will be made available to the different agencies and Ministries responsible for implementing its retained tasks. Such a decision should best be based in a medium-term macro economic framework (MTF) that specifies a binding allocation for the first budget year and indicative ones for say the next two years, reflecting the social and economic policy priorities set at the Cabinet level. Providing in advance such budget envelopes would permit line ministries to better plan their resource use over the coming years, and assist them in prioritizing their expenditures towards the implementation of clearly defined plans. International examples include Uganda which has successfully adopted a MTF framework in its efforts to enhance the result orientation of its budget processes (see Box IV-2). Also, the reforms underway in Benin would be worth studying.

4.46. Once the budget allocation are made, results-based management lends itself to a logical approach. The main steps in the process are: (i) identifying problems in the areas the Government wishes to tackle; (ii) establishing specific and realistic goals to improve upon the existing situation; (iii) specifying how goals will be achieved; and (iv) assessing whether the stated goals were achieved.[58] In order to adopt this approach, it is also necessary to address issues of the incentive system for managers and civil servants to successfully implement the new management process. In addition, the weaknesses of the existing budgetary system – lack of prioritization, transparency, and comprehensiveness – would need to be improved.

[58] A more colloquial statement would be: (i) where are we now; (ii) where do we want to go; (iii) how are we going to get there; and (iv) how will we know that we got there.

Box IV-2. Uganda: Results-Based Public Budget Management Reforms

Some of the measures being undertaken in Uganda to deliver better public services include:

- **Medium Term Budget Framework:** Over the last years, budgeting processes have been significantly strengthened and given a longer term focus through use of a Medium Term Budget and Expenditure Framework (MTEF). This has served as the Government's instrument for shifting spending towards poverty sensitive areas identified under the Poverty Action Fund (PAF). The MTEF sets out the government spending plans over the three year period by budgetary line item and is the basis for prioritizing Government expenditures. Since 1997/98 spending on PAF programs has increased from 17.2 percent of total government expenditures to 24.5 percent in 1999/00.
- **Budget Preparation Process:** Based on the envisioned resource levels, sectors and districts are given three-year spending ceilings within which to prepare their expenditure proposals to the Ministry of Finance.[59] These proposals are the basis for Cabinet decisions on budget allocations.
- **Stakeholder Participation.** The process of budget preparation has been opened up to a wide range of stakeholders.
- **Procurement Reform.** Task force recommendations are being implemented with wide-ranging reforms.
- **Monitoring and Evaluation.** Efforts are being strengthened on monitoring and evaluation (M&E) that shifts away from compliance with government rules and regulations towards end results of policy, program and project efforts. A National Service Delivery Survey findings is expected to be used to establish a baseline, goals and targets for service reach and client satisfaction that are, in turn, brought into work planning.
- **Anti-Corruption Measures.** High level efforts are underway to address anti-corruption measures.

4.47. ***Step One.*** Once the Government decides that it will continue to finance the delivery of a particular service (e.g., preventive health care in a given geographic area), spending agencies should attempt to specify as clearly as possible what these problems are and how they are measured. (e.g., infant mortality rates and prevalence of particular diseases). Available data will need to be systematically gathered, perhaps requiring the commissioning of well-targeted statistical surveys. These data should be presented by administrative area (e.g., district or Governorate), so that staff responsible for the delivery of services have a clear picture of the problem at hand, as this should help them shape their intervention policy. Not all area of intervention can be easily quantified, but by beginning with services that can have numeric targets will make it easier to assess progress.

4.48. ***Step Two.*** Service delivery targets should be established set. In this realism should prevail in order for results-based management to be considered a constructive process. This stage could benefit from comparisons of indicators across geographical areas within the country or even internationally. For example, if illiteracy rates among young adults are high in Upper Egypt compared to the rest of the country, then a possible goal could be to narrow the gap. However, rather than having the Government unilaterally establish priorities within a program, participation of the population, possibly through client surveys or discussions with local government councils, could be used to establish the goals for the budget. An example could be that if the Government desires to improve its performance in delivering electricity, consumers may prefer that the result target should be continuity of the service (i.e., no interruptions) rather than an increase in the number of connections within the district.

[59] The spending ceilings include envisioned spending on PAF programs, ensuring the full integration of the PAF into the budget programming.

4.49. ***Step Three.*** Specify how exactly the Government intends to reach the targets. This would probably require that the budget eventually move towards a program-based format (i.e., primary education, rural roads, or hospital care) rather than the current input-oriented one in order to clearly specify the link between resources and the expected outcomes. At this stage, involvement of the community being affected would be desirable since not only would their concerns be taken into account, but they could offer valuable information on why the previous system may not have worked (i.e., absenteeism among doctors or unavailability of medicines).

4.50. ***Step Four.*** Report publicly on progress achieved, using the progress indicators decided on earlier in the process. This will contribute to holding people accountable for the delivery of services inside the administration and also towards civil society.

IV.3. Some Implications for the Civil Service

4.51. In order for results-oriented management to be implemented, program managers need to be given the authority to make and execute decisions if they are to be held accountable for them. In particular, managers need to be given greater budget flexibility to allow them to allocate resources in a manner they see fit. One approach would be to let them manage their investment and non-wage budget as a consolidated envelope over which they have effective control. Other personnel-related incentive systems could be devised. Concerns regarding the proper use of resources by managers should be addressed by adopting appropriate financial controls, especially for procurement, and a good auditing system.

4.52. However, the biggest challenge that program managers, as well as the Government, will need to face is how to address personnel issues – to hire the number and skill mix of persons desired, remove those persons who are not contributing in the manner requested, and give incentives to attract the desired personnel. Civil servants will need to operate under an incentive and personnel management system that leads them to deliver effectively and efficiently the services for which they are responsible. These issues are key because the quality of service delivery depends greatly upon the civil servants in charge of delivering these services. For example, the quality of education delivered depends largely on teachers and on administrators that manage the system.

4.53. International comparisons suggest that the Egyptian civil service is both overstaffed and underpaid. Civilian wages represent 6.5 percent of GDP and civil servants constitute about 28 percent of total employment and 8 percent of the population In the late 1990's, worldwide total government civilian employment averaged about 4.7 percent of the population (5.7 percent in MENA), and wages represented 7.0 percent of GDP (9.8 percent of GDP in MENA), while the share of civilian wages and salaries amounted to 5.4 percent of GDP (8.9 percent in MENA countries and 4.5 percent in OECD countries). These benchmarks suggest that the Egyptian civil service is rather large, but with an overall burden on the budget that is about average.

4.54. Average salaries in the civil service are equivalent to about 0.8 times per capita GDP, which is lower than in most countries, where the ratio for central government wages ranges from 1.2 times per capita GDP in OECD countries, to 4.3 times per capita GDP in Africa, and 2.0 for MENA countries. In Egypt, average public sector salaries are 35 percent below those paid in the private sector, but for higher level civil servants the gap is even larger for equivalent responsibilities.[60] This compares with civil service wages that are broadly equivalent to private sector wages

[60] Data are for 1995

in MENA, but are 23 percent below private sector wages in OECD countries. Since 1994 average real wages have risen by about 10 percent, as annual increases exceeded the rate of inflation.

V. Conclusion

4.55. Public sector performance could benefit from the greater emphasis on effectiveness of service delivery, already high on the agenda of the Ministry of Finance. Reforms should be gradual and realistic, but bold. They should be gradual and realistic in that the present budget system will need to be revisited and changes introduced gradually. They should be bold in that the vision and the action plan to realize this vision should be made explicit and not afraid of changing ingrained practices; the objectives of the expenditure program should be made clear and procedures introduced to measure achievements and to provide managers with adequate incentives. These are departures from the present way of managing the budget, but the payoffs could be substantial. No country has as yet fully implemented all the elements of the results-oriented budget, but those that have started have greatly benefited in terms of accountability and effectiveness of their expenditure policy.

4.56. While the overall reform process will take time, there are a number of measure that could be taken in the very near future and that would greatly enhance the result orientation of the budget.

- Agree and publicly announce a medium-term macro economic framework with overall and sectoral binding budget ceilings for the next budget cycle and indicative budget envelopes for the coming two years. Reflect these agreements in the Budget Circular.
- Make the budget documents and the reports on budget execution available to civil society in a timely manner.
- Introduce an effective expenditure tracking system, based on appropriate information technology, so as to better monitor budget execution.
- Unify the budget management for the recurrent and the investment budget.
- Launch pilots to introduce a more results oriented budget process in selective agencies; this will require that their budget classification and nomenclature be adjusted and that they define their desired budget outcomes and the indicators that will be used to monitor progress.

Chapter V

Employment and Welfare Developments

I. Introduction

5.1. The Government of Egypt remains concerned by the twin problems of unemployment and poverty. Despite the fiscal cost, it has taken steps to try to minimize the adverse impact of economic developments on the incomes of the population, including the poor, as seen in its protection of social expenditures from cutbacks, continued support of a broad based safety net, and rapid public sector hiring policies. The Government has had a difficult job in the face of declining wages throughout much of the 1990s and slow private sector job creation. The Government's past actions may have helped address problems of unemployment in the short-term but the consequences for the future are of concern. A large civil service will make reform more difficult to undertake and the labor force will continue to look to the Government in times of slow economic growth for jobs.

5.2. The population's welfare will depend upon the quality of life – in terms of health, education, and living conditions – and their ability to find employment at a wage that allows households to meet at their minimum basic needs. The Government has an important role to play in ensuring that living conditions reach acceptable standards by financing public services. It also has the more difficult task of adopting policies that provide an environment conducive to adequate employment creation and to sustainable wage growth based upon improvements in productivity.

5.3. This chapter will provide an overview of labor market issues by discussing trends in labor force, unemployment, employment, and wage growth. The section which follows summarizes available information on poverty and social indicators. The last section assesses public expenditures on education, health, and safety nets.

5.4. The main messages of this chapter are:

- The medium-term outlook for unemployment and wage growth will depend upon the private sector's willingness to invest in order to create jobs and achieve productivity gains. However, women may not benefit since their share in private sector wage employment has been declining.

- Small changes in income could lead to significant changes in poverty since data for 1995/96 indicate that expenditures for the bottom 60 percent of the population lie close to the poverty line.

- Allocation of public expenditures on health and education could be improved to increase delivery to low income groups and reduce regional variation. In general, health and education indicators present a mixed picture of the quality of life in Egypt compared to other lower middle income countries.

II. Labor Market Opportunities[61]

5.5. Developments in the labor market determine to a large extent whether and how the population benefits from economic growth. An economy with robust employment creation and wage growth will lead to improvements in living standards. But for these improvements to be sustainable, the private sector must take the lead role. This section will discuss the key issues regarding employment in Egypt. This will follow on the earlier discussion in Chapter II which discussed employment growth by sector.

II.1. Labor Force Growth

5.6. The labor supply will continue to grow in the medium-term at a robust pace, estimated at 2.6 percent for 2001-2010 compared to 2.7 percent during 1988-1998. The growth in the labor force is being driven by past high fertility rates. Though the absolute number of new jobs seekers will rise until 2006, the rate of growth is forecasted to decrease beginning in 2001. For the next ten years, the average number of new market jobs required annually is about 638,000 per year compared to 508,000 jobs created annually in 1997-1999.

5.7. In the next decade there will be significant changes in the composition of the labor force, with (i) more educated labor, (ii) a higher proportion of women, and (iii) a larger presence of rural-based labor. Increased female and male school enrolment rates in both urban and rural areas have led to higher education levels overall. Higher fertility rates in the rural areas have not been accompanied by equally strong rates of rural to urban migration, leading to significantly larger segments of the labor force emanating from the rural sector. During 1988-1998, the rural population grew by 3.1 percent per year compared to the urban population growth of 2.2 percent. Female participation has increased for many reasons including higher education levels, marriage at an older age, and higher probability of continued employment after marriage.[62]

II.2. Unemployment and Underemployment

5.8. Egypt's official unemployment rate of 7.4 percent for 2000 appears modest in comparison to other developing countries. In part, the low official level of unemployment may reflect an underestimated labor force. Labor force participation rates are affected by whether only persons engaged in "market activities" are included. Usually, this affects the treatment of women engaged in subsistence agriculture for own consumption. The most rigorous unofficial estimate of unemployment rates available are 11.7 percent of the labor force in 1998 when limited to market-based employment. This falls to 7.9 percent when the extended labor force definition is adopted. Another reason for the comparatively low official unemployment rate is that labor migration, especially to major oil-exporting countries in the Middle East, may have provided Egypt a channel for surplus labor. However, little data is available that would allow to ascertain whether to what degree labor migration has helped to curb the unemployment problem in Egypt.

5.9. Young educated adults – both male and female – seeking their first jobs experience the highest rates of unemployment. These new job seekers in both the urban and rural areas have

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[61] This section draws heavily upon "The Transformation of the Egyptian Labor Market: 1988-1998" by Ragui Assaad (ERF, August 2000).

[62] The labor force participation rate among women in the market was estimated at 21 percent in 1998. If women engaged in subsistence agriculture and animal husbandry are included the rate increases to 46 percent.

unemployment rates close to 15 percent, with the exception of young urban women (15-30 years) whose average unemployment rate is closer to 25 percent. By the age of 30-35 years, unemployment falls to about 5 percent. Educated labor, especially those with degrees of intermediate and above have higher unemployment rates, especially among females and rural males. Thus, it appears that in the rural sector in particular not enough jobs are being created that better educated workers deem suitable.

5.10. Underemployment primarily affects rural males, especially less educated labor engaged in casual labor (i.e., irregular jobs). Underemployment occurs if someone works less than 40 hours per week, but would be willing to work more if given the opportunity. In 1998, the underemployment rate among rural males was 6.7 percent. This rate is more than twice as high as that of urban males. Since women rarely engage in casual labor, their underemployment rates are less than 1 percent. Thus, the estimated share of the labor force that was underemployed was 3.4 percent.

Table V.1
Employment by Sector and Gender in the Egypt
(in percent)

	Employment Distribution in 1998			Annual Growth Rate (1988-1998)		
	Total	Male	Female	Total	Male	Female
Public Sector	29	34	21	-2.6	2.6	4.3
Government	24	27	19	3	4.5	5.4
State-owned Enterprise	5	7	2	4.8	-2.3	-4.1
Private Agriculture	39	21	68	1.6	-1.9	4.4
Wage Work	5	8	1	-0.2	0.6	4.1
Non-wage Work	34	14	67	1.9	-3.1	-6.3
Private Non-Agriculture	32	45	11	3	3.9	-1
Wage Work	20	29	5	4.3	4.7	1.6
Non-wage Work	12	16	6	1.3	2.6	-2.7
Total	100	100	100	2.5	1.9	3.4

Source: Ragui Assaad in "The Transformation of the Egyptian Labor Market: 1988-1998", Tables 8 and A11 based upon CAPMAS labor market surveys for 1988 and 1998.

Note: The extended labor force definition is used, it includes women working in subsistence agriculture.

II.3. Employment and Wages

5.11. Employment creation was robust over the past decade and estimated at 2.4 percent during 1988-1998. The annual rates of growth of the private non-agriculture and public sectors were high and their contribution to employment creation was 38 percent and 35 percent respectively. The rate of growth in the agriculture sector was the least, but because of its large size, it still contributed 27 percent of employment during 1988-1998. Almost one-third of all jobs created were non-wage jobs, mostly in agriculture and a much smaller portion in the private non-agriculture sector. The aggregate figures for job creation mask the very different experiences of men and women as well as the wage/nonwage composition of jobs created.

5.12. Trends in employment creation show that men were leaving the agriculture sector and entering the private (non-agriculture) and public sectors. Moreover, there was a decrease in the share of men employed in non-wage jobs. Though the private agriculture sector remains an important employer of men, there were 25 percent fewer men employed in this sector after ten years – all due to an decrease in non-wage jobs. During 1988-1998, the private sector created two jobs for every new job in the public sector. About one-third of the private sector jobs were non-wage jobs which could indicate self-employment in small businesses. Wage jobs in the private sector (which accounted for 44 percent of all jobs created for men) were primarily in manufacturing, construction, and trade and services. In the public sector, the job growth came from government employment rather than public enterprises where they lost an estimated 300,000 jobs.

5.13. Trends in female employment show job creation was faster for women than for men (3.4 percent compared to 1.9 percent per annum) during 1988-1998, but the majority of all new jobs were non-wage jobs in the private agriculture sector (73 percent) followed by government jobs (25 percent). The private non-agriculture sector created only 2 percent of all female jobs and these were in manufacturing and trade and services. In urban areas, educated women appear to be limited to the small finance sector and government employment. In rural areas, educated women are limited to government jobs, since it is infeasible for them to commute to urban areas for other types of wage employment.[63] Thus, developments in the labor market appear to be effectively excluding women from the non-agriculture private sector.

5.14. Real hourly wages over the 1988-1998 period declined in almost every sector of the economy by an average of 3.6 percent and 1.3 percent per annum for males and females respectively. Wages of better paid workers decreased which resulted in compression of the overall wage structure over the decade.[64] Analyses of the labor market surveys suggest that there has been an apparent negative return to basic education, both in terms of employment and wages. Unemployment peaks among those with intermediate levels of education. In the mid-1990s, unemployment among those with intermediate education was 33 percent, compared with 1 percent for illiterates. Over the 1988-1998 period, there was falling educational wage premium for all but the lowest end (read and write and primary education) and the highest end (university) of the educational ladder.[65]

II.4. Medium-term Issues in the Labor Market

5.15. What are the main labor market issues that will face the Government in the medium-term? This section tries to identify what the Government may expect in the next several years and what trade-offs it faces in its attempt to improve labor market outcomes while still maintaining significant control over the economy and continuing to be the single largest employer. There are three main issues in the medium-term which are discussed below.

5.16. The outlook for unemployment is unclear in the medium-term. Past employment and growth trends suggest that if the economy grows by 4-5 percent per annum unemployment will remain constant. However, past experience – even recent – may not be a good predictor for the future because of the changing composition of employment. First, job creation during the slow growth period was due in significant part to the government hiring and not due to the private sec-

[63] Assaad, 2000.

[64] Said, 2000.

[65] Ibid.

tor. Thus, though the private sector has created 83 percent of all jobs during 1998-1999, it created far fewer jobs during the structural adjustment period when the economy grew relatively slowly. Any slow down in the economy could see the private sector rate of employment creation decrease significantly. Second, since enrolments have been rising (which is a positive development), open unemployment will tend to rise because 20-30 year old educated labor force participants enter into job search for much longer periods of time as they look for "appropriate" employment. Third, since women are not obtaining jobs in the private sector and decrease in government hiring is decreasing, female unemployment is likely to continue to grow..

5.17. Sustainable wage growth in the future will depend on productivity gains in Egypt. According to sectoral data, productivity grew by 1.4 per annum during 1991-1999. However, if we exclude the services sectors because of the large contribution by the government sector, worker productivity increased by only 0.2 percent per annum. (Even the TFP analysis in Chapter II showed that productivity had not increased significantly during this decade.) Another factor which could affect overall wages in Egypt is the government wage rates. If the Government is seen as an important employer, then educated young men and women will maintain high "reservation" wage rates and not accept private sector employment unless these jobs can compete in terms of wages or employment conditions. Not only would this lead to open unemployment, but because private business will not pay wages higher than (marginal) productivity, total employment creation will be lower. Government wages during 1998-1999 increased by 9 percent in real terms, though after years of decline.

5.18. Significant increase in earnings could occur independent of wage gains, if women's participation in the work force increased. Households with two wage earners are significantly less likely to be poor than those with one earner. However, women's employment in the private non-agriculture sector is falling. Given modern production techniques, may change as seen in the case of developing countries that expanded manufactures using female labor. Not only does this increase household earnings, but it also serves to keep wages from rising and keeps the country internationally competitive. Furthermore, it should be noted that if it is perceived that that investment in women's education does not have a payoff, this could lead to lower investments in women's education in the future. This would not only have implications for the educational level of women, but also of other outcomes such as returns to children's education, children's health, and family income[66].

III. Changes in Welfare

5.19. Two sources of monetary indicators of welfare are national accounts and sample household survey data. National accounts are aggregated over the whole population and are consistently available on an annual basis. But they tell us little about the distribution of resources among the population. Household survey data measure expenditures for a sample of the population. They are useful in estimating poverty and inequality as well as determining the characteristics of the poor and nonpoor. However, household surveys are carried out infrequently and monitoring the impact of economic policies on poverty cannot be done.

5.20. The availability of data in Egypt that can be used to measure changes in welfare is low. The national accounts data provides some information, but even there important data are missing. For example, the Government no longer collects data on the components of gross national income

[66] Handoussa, Heba, "Implementing Social Development in Egypt: The Economic and Budgetary Dimension." Paper prepared for the National Conference on Social Development; October, 1999.

such as wages and profits. Household expenditure surveys were carried out in 1990/1991 and 1995/1996 by CAMPAS and in 1997 by the Ministry of Supply and Trade. Another household survey has recently been undertaken by CAPMAS, but the results will not be available for several months.

5.21. The remainder of this section has four parts. The first two parts analyze changes in welfare based upon aggregate economic data and household survey data. The third section makes an international comparison of poverty. The last section discusses non-monetary indicators of welfare.

III.1. National Accounts Data

5.22. Output growth was robust throughout the 1990s such that by 2000 GNP per capita was LE 5,395 annum (or US$ 1,583). However, private consumption is a better indicator of people's welfare since it excludes the resources allocated to investment and government consumption. During 1990-2000, private consumption per capita increased by 22 percent in real terms to LE 3,831 per capita (US$ 1,124) in 2000. This implies that on average a family of five persons would consume the equivalent of LE 1,600 per month which seems high compared to the average salary earned in the public sector.[67]

5.23. National accounts data indicate that the Egyptian population in the aggregate experienced an improvement in the standard of living as measured by output and by private consumption per capita. However, peoples' consumption growth slowed in the post-1997 era in comparison to output as the share of investment rose. Interestingly, the two years where private consumption per capita fell marginally were in 1992 and 1998 – both years of economic significance (i.e., the start of the stabilization program and the year of a severe decline in tourism receipts).

III.2. Household Sample Survey Data

5.24. Poverty estimates for Egypt have not been updated since the mid-1990s when the shares of the poor and the ultra poor were an estimated 23 and 7 percent of the population respectively. In the interim period, the economy has grown substantially, but the impact of this recent growth on poverty is unknown in the absence of an analysis of household survey data. If economic growth was broad based where the poor and the affluent alike participated equally, then average incomes would have risen leaving the level of inequality the same. On the other hand, growth may have been accompanied with redistribution of income which could have left the poor better or worse off depending upon whether they gained or lost additional income. Furthermore, important structural changes have occurred, such as amendments to the tenancy law, which may have affected poverty levels as well.

5.25. The only relevant information we have for observing changes in poverty is for the first half of the 1990s which, though out of date, may be useful in shedding light on poverty and inequality dynamics in Egypt (see Table III.2). According to Institute of National Planning's (INP) analysis of the household data, total poverty declined from 25 percent to 23 percent of the population during 1990/91 and 1995/96. However, urban poverty increased but was offset by a substantial fall in rural poverty. INP's statistics on inequality are presented only in disaggregated

[67] Recent wage data are not available at the economy wide level. However, an estimate of government salaries can be made on the basis of the wage bill and the number of government employees.

form for urban and rural Egypt. These data indicate that inequality declined in both urban and rural populations as measured by the Gini coefficients. This occurred because of the top 20 percent of the urban and rural populations did not see as high income gains as did the rest of the Egyptian population.

Table V.2
Egypt: Poverty Trends

	1990/91			1995/96		
	Urban	Rural	All	Urban	Rural	All
Headcount (in % of sector's pop.)	20.3	28.6	24.9	22.5	23.3	22.9
Poverty Gap (in %)	4.3	4.5	4.4	4.9	4.3	4.6
Distribution of Poor (in % of pop.)	35.8	64.2	100.0	43.9	56.1	100.0
Number of Poor (in ml)	4,737	8,493	13,230	5,910	7,563	13,473
Gini Index	34.0	36.0		33.1	23.5	
Decile's share of total expenditures:						
Top 10%	28.1	28.2		27.7	21.1	
Top 20%	43.0	43.1		42.2	34.8	
Middle 40%	36.7	37.2		37.4	39.5	
Bottom 20%	8.2	7.0		8.4	11.3	
Memorandum Items:						
Share of Population (in %)	44.0	56.0	100.0	44.7	55.3	100.0
Population Size (in thousands)	23,333	29,696	53,029	26,268	32,458	58,726

Source: *Egypt Human Development Report 1996*.
Note: "Pop." refers to population and "ml" to million.

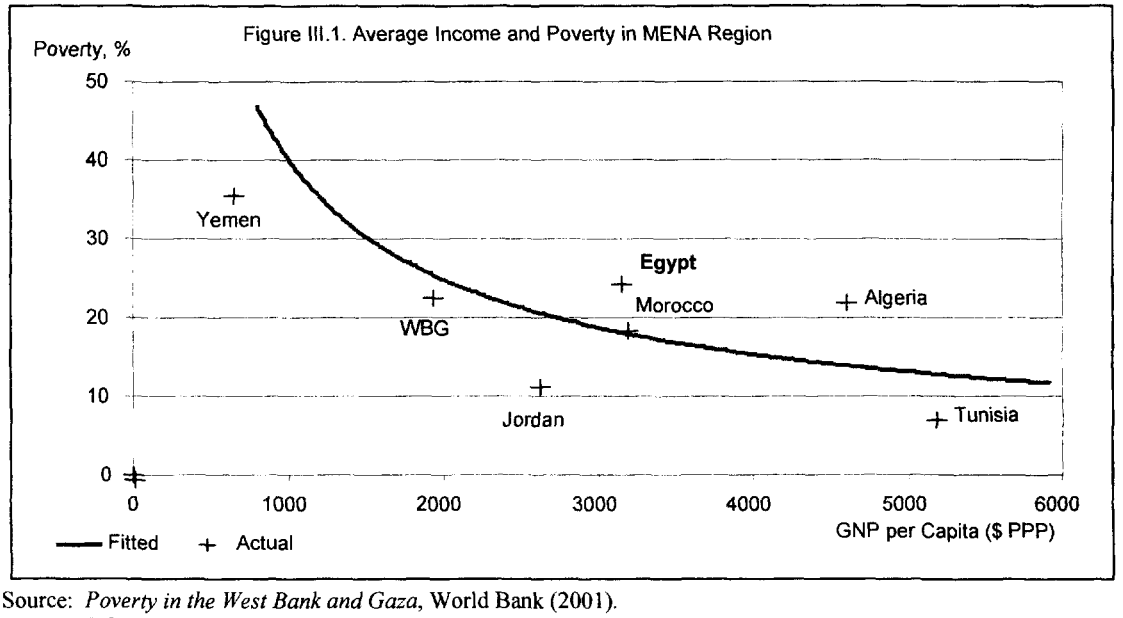
5.26. The distribution of expenditures in Egypt reveals that small changes in income could lead to significant changes in poverty. On the positive side, a large share of the poor, especially in rural areas, lived just below the poverty line in the mid-1990s. Thus, even modest income growth – such as the growth estimated in the rural sector over the last five years[68] – would be capable of lifting a large segment of the poor to above the official poverty line[69]. On the negative side, a large share of the population – almost 35 percent – live fairly close to the poverty line such that an economic shock could push them into poverty. For example, the average per capita expenditures of persons in the sixth decile (or about three deciles *above* the poverty line) were only 30 percent higher than the poverty line.

5.27. What are the characteristics of the poor in the mid-1990s? There are at least three studies on poverty in Egypt in the mid-1990s that provide a profile of the poor. Their findings show that

[68] Over the 5 year period since the last HIECS survey, while overall growth per capita is estimated to exceed 4 percent per year, per capita growth in agriculture, the primary rural activity, is estimated at 1.8 percent per year.

[69] According to the expenditure distributions given in 1995/96, for example, the average expenditure per capita of all households in the 2nd decile would have only needed to grow by 0.7 percent a year to reach the poverty line by 2000/2001. In urban areas, the average expenditure per capita of all households in the 2nd decile would have only needed to grow by 2.2 percent to reach the poverty line by 2000/2001.

the characteristics of the poor in Egypt are similar to what is observed in other developing countries. The poor tend to come from large households where the dependency ratio is high due to the large number of children. The poor have less education and much higher rates of illiteracy than the nonpoor. The sex of the head of household is also a determining factor in poverty. Female-headed households, which account for about 15-20 percent of all households, are 30-50 percent more likely to be poor than male-headed households (in rural and urban areas, respectively)[70].



Source: *Poverty in the West Bank and Gaza*, World Bank (2001).
Note: WBG refers to West Bank and Gaza.

5.28. The poor have few assets other than their labor, therefore employment is essential not only for the well being of the household, but also its survival.[71] In a study which estimates poverty at 27 percent of the population, an estimated 28 percent of all unemployed are poor according to the most recent available data from 1997. The unemployment rate is higher among the poor than the nonpoor – 14 percent compared to 12 percent. The largest differences in unemployment rates are between male and females whether poor or nonpoor. The average unemployment rates among poor women and men are 37 percent and 8 percent respectively. High unemployment among women can push families headed by women into destitution or prevent households from escaping poverty due to the lack of a second income. The lack of employment opportunities for females has affected both their participation rates and their investments in basic education, with only 17 percent of all women[72] in the labor force. Females average 2.7 less years of schooling than males, and have double the probability of being illiterate.

[70] IFPRI, 1997.

[71] The *Human Development Report (1996)* did not have information on employment status by poor and non-poor. Thus we use the results of the IFPRI poverty report for 1996. The headcount index is estimated at 27 percent and unemployment is estimated at 12 percent.

[72] Over age 6 years.

III.3. International Comparison of Poverty

5.29. How does Egypt's poverty level from the mid-1990s compare to other countries in the region and at a similar stage of development? Data for poverty rates exist for about 80 countries including six countries in MENA, namely Algeria, Jordan, Morocco, Tunisia, West Bank and Gaza (WBG), Yemen as well as Egypt (1996). Of these six countries, only Yemen and WBG have poverty rate higher than Egypt. In the case of Yemen, the high poverty rate should be seen against the background of a much lower level of average income: US$ 260 as compared to US$ 1,100 in Egypt in the mid-1990's.[73] In the case of WBG, poverty was affected by the political events.

5.30. The poverty level in Egypt is above what would have been predicted by regional and development standards, though not overly so. In order to compare Egypt's poverty incidence to other countries, we first need to correct for differences in the cost structures. Figure III.1 shows PPP-corrected GDP per capita and poverty rates in the MENA as well as an estimated relationship between the two.[74] The graph suggests that the level of poverty in Egypt is primarily the result of the low level of economic development and only to a secondary degree the inequalities in income distribution (as compared to other countries). Since INP did not provide an overall Gini coefficient for Egypt, it is difficult to ascertain whether Egypt's degree of income inequality is high by international standards. Thus, pro-poor policies that coincide with economic growth may prove more effective than those seeking redistribution of income.

Table V.3
International Comparison of Selected Social Indicators

	Mortality Rates	Life expectancy at Birth		Young Adult Illiteracy rate /1	
	Under-5 years	Male (in years)	Female (in years)	Male (% males 15-24)	Female (% females 15-24)
Egypt	61	65	68	24	38
Middle East & North Africa	56	67	69	13	24
Low income countries	116	58	60	19	31
Middle income countries	39	67	72	4	6
Lower middle income	40	67	72	3	7
Upper middle income	34	66	73	5	4
World	78	65	69	...	...

Sources: WDI (1999) for all years.

III.4. Non-Monetary Indicators of Poverty

5.31. The discussion of poverty above is limited to using a money-based indicator, i.e., private expenditures. Consumption indicators do not take account of the cost of accessing social and physical infrastructure services, though they may be unevenly distributed. An alternative approach to measuring the extent of deprivation in a society is to use social indicators which may be

[73] GNP per capita using Atlas method of calculation for cross-country comparison.

[74] The fitted line is obtained by regressing poverty rates on log of GNP (PPP) per capita using observations for 79 countries as well as regional dummies.

more representative of the basic aspects of the quality of life of the population. The drawback of course is that these indicators are only averages and we do not know the degree of variation among various population groups. The two areas for which indicators are available are education and health.

5.32. Progress in health and nutrition has generally exceeded what other countries at similar initial levels have achieved. Nevertheless, since Egypt has only recently joined the ranks of the lower middle income countries, its indicators are comparatively poor. When we look at the key indicators of health – infant and under-5 mortality rates, immunization rates, births attended by health staff, malnutrition, and stunted growth for under-5 year olds – it is apparent that the Government still has a large agenda that remains to be fulfilled. Despite improvements, the health of young children remains of particular concern. For example, 6 percent of all children under the age of 5 years die; 25 percent of children under the age of 5 years old are physically stunted due to poor nutrition; and about 12 percent of children under 5 years are malnourished.[75]

5.33. Illiteracy remains a major hurdle for the economy to overcome. Progress in eradicating illiteracy over the decade has been the poorest in the region, and poor internationally, given its initial income and illiteracy levels[76]. While adult illiteracy in Egypt has declined over the decade, it remains high, with 45 percent of the population illiterate in 1999[77]. Of even greater concern, about 31 percent of the *young* adult population (15-24 years old) is illiterate, foreshadowing a potentially immense employment problem in the future. Over the last decades, the international standards for education to compete successfully have been raised. In many industries, the ability to compete successfully depends upon a relatively more educated workforce. In terms of poverty reduction, concerns over slow progress in reducing adult illiteracy are statistically well grounded. In Egypt, those who are illiterate are 75 percent more likely to be poor than are those who can read.[78]

IV. Public Expenditures on the Social Sectors

5.34. The poverty profile from the mid-1990s underscores the importance of both employment and education in determining poverty outcomes. Fostering the conditions for economic growth that translates into productive job creation for the poor should be considered a key priority in Egypt's overall poverty reduction strategy. The public sector also has the vital role of providing access to the physical and human assets that are found to reduce the risks for poverty. Over the 1990s, the Government of Egypt has demonstrated a commitment to its social expenditure program, despite embarking upon strict fiscal austerity. At the same time, however, outcomes from the state's two most vital interventions for long-term poverty reduction – education and health care – suggest opportunities for improving efficiency of social sector spending. These social services are also not reaching as high a proportion of the low income groups as the high income groups and therefore, suggesting that more could be done to equalize the distribution of expenditures.

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[75] Source of data is World Development Indicators, World Bank (1996-1999).

[76] Egypt's infant mortality rate declined from 69.4 per 1000 live births in 1990 to 49.1 in 1998, but regression analysis would have predicted Egypt's infant mortality rate to decline to only 57.3 1998. Child mortality rates declined from 85 per 1000 live births in 1990 to 59 in 1998, but regression analysis would have predicted that rate to decline to only 70.

[77] Down from 52.9 percent of the population in 1990.

[78] IFPRI: Probability(poor) for illiterates is 31.9 percent, versus only 18.2 percent for those who can read.

5.35. The criteria often employed in assessing a public expenditure program are effectiveness, efficiency, and equity. Effectiveness is often assessed according to (i) the proportion of the target group who have access to assistance ("coverage"), (ii) the proportion of assistance which is directed to the poor ("leakage"), and (iii) the adequacy of the assistance in helping achieve the program's goals. Efficiency criteria determine whether the same level of assistance can be provided but at lower cost. Equity deals with the distribution of expenditures and program outcomes across the target population.

5.36. The remainder of this section will discuss some important public expenditure issues in education, health, and safety nets.

Table V.4
Distribution of the Children Not Attending School, by Income Quintile
(in percent)

Age (in years)	First	Second	Third	Fourth	Fifth	Total
7 to 11	50	28	13	8	2	100
12 to 14	48	30	12	6	4	100
15 to 17	28	34	16	12	10	100
						100
7 to 17	34	26	20	13	7	100

Source: IFPRI, 1997.
Note: The first income quintile refers to the poorest 20 percent of the population.

IV.1. Education Sector

5.37. Government commitment to education is strong as reflected in the proportion of its budget allocated to this sector. Whereas overall budget spending fell from 32 percent to 28 percent of GDP between 1994 and 1999, the share of education rose from 2.9 percent to 4.2 percent of GDP over the same period, with recurrent expenditure increasing somewhat faster than investment expenditure[79]. Even though this share is still lower than the 5.1 percent of GDP spend on education by the average lower middle-income country it represents a substantial fiscal effort during a period of general fiscal austerity. Investment expenditure in the sector represents 24 percent of overall education expenditure. This is much higher than in the OECD countries, where this share generally is about 7 percent, and in developing countries where this share is still lower.

5.38. The effectiveness of Egypt's education expenditures can be assessed by looking at enrollments and quality of education in terms relevance for employment. According to the first criteria, Egyptian's access to primary and secondary education has increased considerably over the past decade. Primary and secondary enrolment rates are comparable to the average for lower middle income countries. Two noteworthy differences at this aggregate level are (i) that female primary net enrolments are 91 percent compared to 97 percent for comparator countries; and (ii)

[79] A detailed review of the education spending at all levels of government puts the 1996/97 share at 5.2 percent of GDP.

male secondary enrollment rates are higher than that of lower middle income countries, possibly because of the Government's past employment guarantee program.[80]

5.39. The quality and relevance of education – also called "external efficiency" – could be substantially improved.[81] External efficiency is achieved when the education system delivers graduates with the type of skills that are in demand by society. High levels of unemployment of graduates suggest that substantial inefficiencies prevail. For example, in higher education, universities enrollment policies are not based upon labor market demand in general or even by faculty/subject (especially for training doctors and teachers). At the intermediate level, vocational schools could also be improved. Skills that are being taught are too much oriented towards the old economy with too little attention for the skills that are required in the modern economy.

5.40. The "internal" efficiency of education could be improved by using existing resources to increase enrolments and raise the quality of teaching services provided. Two major problems exist which adversely affect internal efficiency. First, there appears to be an excessive number of administrators – the ratio of administrator to teacher is 1:1. The second problem is the deployment of persons hired as teachers in the schools. The student-teacher ratio appear to be low (in 1997 they are 24 and 13 for the primary and secondary levels), but complaints of over crowding in schools are not uncommon. The low ratios may be deceptive in that they do not capture whether or not the teachers are actually teaching rather than being involved in administration. Other issues regarding efficiency include whether teaching loads reach a level to make the provision of services sensible, especially in vocational training.

5.41. Equity could be improved in the education system by improving the distribution of services across income groups and regions and by determining ways to lower the out-of-pocket expenditures for low income students. Lower income groups are less likely to benefit from public education expenditures than the affluent; the poor have on average 2.6 years less schooling than the non-poor, and their literacy rate is 27 percent lower than the non-poor. In every age group,[82] children not attending school are predominantly from the lower income quintiles. For example, for those aged 7 to 11 not attending school, some 50 percent were from the bottom income quintile, and more than three quarters came from the bottom 40 percent of the population, in terms of expenditures. Regional disparities exist for primary and secondary enrolment rates. For example, attendance in basic education differs significantly, depending upon the governorate. The share of children aged 7-11 (primary school age) not attending primary school[83] ranges from less than 1 percent in the Suez, Damietta, and Menoufia governorates to almost a quarter in the Fayoum Governorate[84].

5.42. Cost appears to be a major factor in the educational decisions of the population in general, but is particularly important for the poor. The IFPRI poverty profile found that half of the

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[80] Data for 1997. Source: WDI.

[81] The quality of education is difficult to judge in terms of international standards since Egypt does not participate in any international assessments of educational quality. However, experience from elsewhere in the region indicates that potential areas of weakness may lie more in the area of children being able to apply their mathematical and science knowledge to solve problems rather than in their knowledge of facts.

[82] Ages 7-11 years; 12-14 years; and 15-17 years.

[83] Excluding children who have completed primary school.

[84] Egypt Public Expenditure Review of the Social Sectors; January 6, 1999; World Bank.

children not attending primary school cite financial grounds as the principal reason, and financial issues are significantly more important in the decision not to continue school for the poor than for the non-poor. Determining ways to mitigate the direct and indirect costs of attending primary school (such as providing scholarships) would have a meaningful impact on the educational achievements of the poor. Household level survey data on the use of education services could significantly improve the Government's understanding of those direct and indirect costs. These data have been collected by CAPMAS but it is reluctant to release the raw data which is essential for carrying out this analysis.

IV.2. Health Sector

5.43. Over the last two decades, Egypt has achieved significant improvements in the health status of its population. Between 1980-1998, child and infant mortality rates declined by almost two thirds, fertility rates dropped by 60 percent, and life expectancy increased by 20 percent. The Government has invested heavily over the years to develop a health care system to try to meet the needs of its citizens. Though data on public expenditures on health are only available for the last few years, the Government appears committed to protecting the health sector from the wake of overall fiscal austerity. Public expenditures on health increased from 1.6 percent of GDP in 1995 to 1.8 percent of GDP in 1997, at a time that public spending declined from 34 percent to 31 percent of GDP.

5.44. Evaluating the effectiveness of the health system is complicated, since many factors, including education and access to sanitation and safe water, influence the general health of the population. However, comparing Egypt to other lower middle-income economies shows that while several health-related infrastructure outside the formal health system (sanitation, safe water) are more advanced in Egypt than in other lower-middle income economies, all of the traditional indicators of the population's physical well-being are below those of comparable countries (see Table). The health care system as a whole is under-funded. Only 3.8 percent of GDP is spent on the health sector in Egypt, relative to 5.3 percent spent by comparable countries. With per capita health care spending in 1997 of $48 in Egypt, versus $115 for other lower-middle income economies, additional resources devoted to the formal health sector could potentially narrow the gap in health indicators.

Table V.5

General health indicators and determinants, 1997[1]

Health indicator/determinant	Unit	Egypt	Lower-Middle Income Countries
Sanitation	percent of population with access	87	78
Safe water	percent of population with access	94	79
Immunization	percent of children under 12 months	93	88
Maternal mortality	per 100,000 live births	170	91
Infant mortality	per 1000 live births	51	32
Child mortality	per 1000 live births	66	39
Malnutrition prevalence	percent of children under 5	12	9
Stunting prevalence	percent of children under 5	25	18
Life expectancy at birth	in years	66	68

Source: WDI for all except sanitation and safe water access which is from the Live Data Base.

Note 1/: Or most recent available estimate.

5.45. There is also indication that equity could be substantially strengthened. Public expenditure on health services varies widely among governorates, but does not reflect the equally wide variation in health conditions by governorate. Conditions appear to be poorest in Upper Egypt, especially in rural areas, and in rural Lower Egypt – but provision, as measured by the distribution of both the public sector health workforce and numbers of hospital beds, indicates a strong bias toward urban areas and Lower Egypt. Health status and expenditure optimization considerations suggest the desirability of a closer correlation between public spending and governorate-level health indicators.

5.46. In 1988 the Government embarked upon an ambitious Health Sector Reform Program (HSRP), designed to be a blue-print for a comprehensive reform of Egypt's health sector over the next two decades. The reform begins to consolidate the fragmented health financing system within the framework of a national health insurance program. This is a positive step, as it permits the Government to incorporate the services provided by private health care providers as it considers its own allocations to particular localities, and would reduce duplication and wastage of resources among the many providers.

5.47. Finally, there is also significant scope for improved efficiency. 40 percent of spending by the Ministry of Health and Population (MOHP) is directed to investment expenditures. These large investment programs seem to respond to pressures to finish previously started investments, though much could be gained by making more efficient use of available infrastructure. Recent estimates suggest that only half of the beds in public hospitals are being occupied, and that only one third of the beds in hospitals run by MOHP are occupied. As these hospitals account for 58 percent of all hospital beds, an effort of rationalization might well start there. An additional issue is that recurrent expenditure allocations throughout Egypt are guided by the number of hospital beds available, without regard to actual occupancy, with furthers the problem. Rationalization of the hospital sector, including closing some facilities with utilization rates or that are too low to operate efficiently, combining some facilities with others to achieve economies of scale, or converting them in to other health service facilities, could further the effectiveness of the MOHP's scarce resources.

5.48. Another issue affecting the efficiency of public health spending has been the large allocation of spending to curative services (56 percent of MOHP expenditures). In light of the fact that Egypt still suffers from many communicative diseases and that some basic health indicators are still low, this large share of the budget devoted to curative service deserves to revisited . New investments heavily favor expensive curative services such as open heart surgery and renal dialysis, much of which is financed through the MOHP budget that is otherwise reserved for serving the poor. Public spending and health considerations suggest the need for refocusing health expenditure more toward primary services, essential for addressing the communicable diseases from which Egypt still suffers, and for reducing unacceptably high rates of maternal and neonatal mortality.

5.49. The Government's health care system's performance is also impacted by the quality of services provided by medical staff. Public sector medical staff appear to be too numerous, at times under-qualified, and under-motivated, in part because of low remuneration. Past recruitment policies, with pressure for the public sector to hire most of the medical school graduates, has led to a doctor to population ratio of 1.6 per 1000 population. Regression analysis suggests that, given its per capita income, Egypt should have only .75 doctors per 1000 population. As universities are on track to produce about 4000 doctors a year till 2002, this situation could worsen, if recruitment policies remain intact. It has been estimated that the public sector should recruit no more than 820 a year if it wishes not to increase the ratio of doctors per population any further.

There should be some signaling to universities about his situation, to reduce their intake of new medical students, a responsibility that should be shared between the MOHP and Ministry of Higher Education.

IV.3. Social Safety Nets

5.50. Egypt has three main safety net programs, which together account for about 2 percent of GDP or about 4 percent of total government expenditures in 1999. The largest of these programs is the food subsidy program, which absorbed 1.5 percent of GDP in 1999. The other two programs are the Social Fund for Development (SFD), established in 1991, and the (mainly cash transfer) payments to specific categories of the disadvantaged by the Ministry of Social Affairs (MOSA). Overall, food subsidies account for 85 percent of safety net expenditures, SFD for 13 percent, and MOSA transfers for just over 2 percent. Total public spending on all three programs combined has grown on average by about 3 percent per annum in real terms beginning in 1992. Much of the increase in funding since the early 1990s is attributable to Government support for the SFD, which increased by 4.0 percent per annum compared to only 0.1 percent per annum for the food subsidy program. MOSA safety net spending is small and has not increased substantially in recent years.

5.51. The effectiveness of the safety net can be measured by the degree of poverty it helps to reduce. Since about one-fifth of the population lives in poverty despite government expenditures, the safety net does not reach all the poor. Eliminating poverty in Egypt would cost an estimated 0.8 percent of GDP or 2.9 percent of total public expenditures – assuming perfect targeting. This amount could rise significantly if we make more realistic assumptions about leakage to the nonpoor. Since over half of the poor live in the rural areas, reaching them will be more difficult. Furthermore, because of the compression of expenditures in the first six deciles, distinguishing the poor from the nonpoor will be difficult and high leakages can be expected.

5.52. The three major safety net programs do indeed help the poor as well as prevent others from falling into poverty. For example, food subsidies appear to have improved nutrition s they comprise nearly 40 percent of the poor's caloric intake. They also raised the real income of the poor by about 10 percent and probably pushed the poor near the poverty line to above it. Since the difference in expenditures of the first six deciles is fairly small, poverty could have been reduced significantly with this program. The social aid program has not been evaluated, but it is believed that leakage is not high from this program. The number of direct beneficiaries reached about 230,000 persons in 1998. This number could increase by 3-5 fold depending upon the household size of families receiving assistance. The social fund has two poverty alleviation programs, the Public Works Program and the Community Development Program which target poor communities as well provide employment opportunities to the poor.

5.53. The efficiency of safety net expenditures is probably its greatest weakness. This is due to the consumer food subsidy program which constitutes about 85 percent of total safety net expenditures. The Government subsidizes coarse baladi bread, coarse baladi wheat flour, edible oil and sugar. If the total subsidy expenditures were spent on the bottom 20 percent of the population, it would have resulted in a transfer of LE 270 per capita which is substantial compared to a poverty gap of about LE 356.[85] Aside from the leakage of subsidies to other *consumers*, there is also a

[85] The poverty line in 1996 in 1999 Egyptian pounds is LE 934. The difference between the poverty line and average expenditures of the bottom 2 declines was LE 311in 1996 equal to LE 355 in 1999 pounds.

concern that perhaps the illegal diversion of subsidized grain, flour, and bread to open markets is occurring. There are steps that can be taken to reduce this such as blending wheat flour with white maize at the mill – maize flour is an inferior good.

Chapter VI

Conclusion

6.1. This report discusses issues in four areas: (i) macroeconomic developments and growth, (ii) trade liberalization and private sector development, (iii) employment and welfare, and (iv) public sector reform. The specific issues chosen were based upon what were considered to be the most pertinent for the long-term development prospects for Egypt out of the set of issues for which information was available. Thus, topics such as the financial sector, the impact of policies on poverty, and the large national infrastructure projects as discussed in Chapter I were not considered though they are of vital importance.

6.2. Each chapter yielded several important conclusions. In this section, we distill the report's conclusions further in order to help prioritize five main areas that the Government may want to consider for reform. The main messages of the report are as follows:

6.3. First, in order to maintain Egypt's robust economic performance of the late 1990s, the Government will need to continue to implement reforms. The appreciation of the real exchange rate combined with low productivity gains have eroded Egypt's international competitiveness making it more difficult to pursue an outward-oriented growth strategy. The most important step that needs to be taken is to maintain stability of the macroeconomic environment by strengthening economic management which may have been pushed off-course by exogenous shocks in the latter half of the 1990s.

6.4. Second, trade liberalization remains an unfinished and critical area for further reform. By sharply reducing tariffs and other trade taxes, especially on manufactures, Egypt can achieve productivity gains and wage growth. Reform in this area should be initiated first, since otherwise foreign direct investment attracted will be of the "tariff-jumping" nature and is unlikely to improve domestic competition or export performance. However, trade reform will need to go hand-in-hand with tax reform because of the implied loss of revenues.

6.5. Third, it is important to revisit government regulations that increase the cost of doing business in Egypt. Though the Government has taken many important and essential steps to improve the investment environment, Egyptian markets will be more competitive if the barriers to entry and exit from the market are further lowered. This will benefit Egyptian consumers, especially low-income groups who can ill afford to pay prices above international levels.

6.6. Fourth, expenditures of the bottom half of the population appear to be fairly compressed. In 1996 the bottom 60 percent of the population at most had expenditures per capita 30 percent above the poverty line. Thus, small shifts in income could have large implications for the population's welfare. Policies which improve workers' access to jobs in high productivity sector, such as manufacturing, are key to a poverty reduction strategy.

6.7. Fifth, the quality of life of the population is in part determined by public services such as those that enhance health, education, sanitation, clean water, and air quality. The first step to ensuring that the nation's resources are better spent in these areas is by taking steps to improve the results-orientation of the budget, especially the recurrent budget.

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Annex I.1

Fiscal Sustainability Analysis[86]

AI.1.1. Current levels of debt and fiscal deficit in Egypt are high in comparison with similar middle-income countries. In 1999, the fiscal deficit reached 4.2 percent and the ratio of debt to GDP surpassed 88 percent. The level of public debt to GDP in particular is considered as an important indicator of fiscal sustainability, although there is no general agreement on the threshold above which debt is considered unsustainable.[87] Using 1999 as a base year for fiscal sustainability analysis and assuming that all the economic conditions that Egypt faced in 1999 hold for the coming decade (same real GDP growth, real domestic and external domestic interest rates, and inflation rates; no currency devaluation and a primary budgetary surplus in the order of 1.2 percent of GDP), then debt to GDP and budget deficit to GDP will continue to fall in the coming decade, reaching 67 percent and 3.1 percent respectively in 2009. This is considered as the base line scenario although the assumptions are too restrictive and appear unrealistic.

AI.1.2. The fiscal sustainability analysis relaxes the above assumptions individually and simultaneously to assess the impact of these changes on the fiscal stance. The results (Table AI.1) reveal that Egypt is likely to face a difficult fiscal stance if GDP growth rates decelerate, currency devaluation occurs, or if domestic and external interest rates increase. Preliminary data for 2000 and the medium-term outlook indicate that the possibility of worsening of the three variables simultaneously. For illustration, if the real domestic interest rate increases from 6 percent in 1999 to an average of 8 percent in the coming decade, an additional 14 percentage points (and 2.4 percentage points) will be added to the ratio of debt to GDP (and budget deficit to GDP ratio) by 2009. The major fiscal risks, however, remain in the change in the ratios of government spending and revenue to GDP. Currently, the budget enjoys a primary surplus (excluding interest payments) and the ratio of debt to GDP will, therefore, continue to decline.[88] However, there are many risks that may affect both government revenues and expenditures.

AI.1.3. The level of total revenue, at about 24 percent of GDP, is broadly similar to other countries at a similar stage of development. The structure of revenues is different, however, as a significant portion of revenues has historically come from rent revenues from oil and the Suez Canal. Only 14.5 percent of GDP is collected in non-rent tax revenue in 2000. The principal reason for the low tax revenue is the poor yield from taxes on personal income and consumption. In addition, lower middle income countries (LMICs) as a group collect higher taxes on goods and services. The prospects of revenue expansion is substantial particularly for Egypt's low tax revenues (e.g., income and consumption). However, there are also risks that revenues may decline as a result of decline in transferred profits due to declines in Suez Canal dues or low oil prices. Tax revenues also are likely to decline as a result of tariff reductions to meet the obligations of the multilateral trade agreements. Egypt tax on international trade is already high in comparison with other countries. During 1995-1998, taxes on international trade constituted 12 percent of total current revenue while the ratio has been 9.7 percent for the group of LMICs (e.g., 2.8 percent in Turkey, 3.9 percent in Mexico and 5.4 percent in Poland).

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[86] All years fiscal years unless noted otherwise.

[87] If debt to GDP is projected to increase indefinitely and to or if cost of debt servicing absorbs an excessive amount of resources, then debt is considered unsustainable [see IMF (1995)].

[88] Excluding the net lending of NIB to non-government sector, pending the audit of the NIB.

AI.1.4. The scope for further spending cuts is somewhat limited because of the rigidities in most current expenditure items. First, wages and salaries, —6.5 percent of GDP and 23 percent of total expenditures in 2000 – continued to rise because the GOE continued to apply annual adjustment to civil service wage of 10 percent despite the decline in the rate of inflation. In 1995-1998, the burden of the wage bill in Egypt on total spending was similar to other LMICs as a group. If wage bill increase at 10 percent annually, it will soon be the largest component in the budget. Second, Egypt's interest payments as a share of total spending by far exceed the corresponding shares in all comparator countries. Although, interest payments on foreign debt continued to decline, the burden of the domestic debt has increased significantly and will remain higher in the short and medium terms. There is also a potential for increased government spending due to assumption of contingent liabilities or increased spending in the social sectors. Higher investment spending on mega projects is likely to remain high in the short and medium terms. While recognizing the development potential of capital expenditure, strict assignment of spending priorities will be required to remain within the overall deficit target.

AI.1.5. The major fiscal risks, therefore, include: a deceleration in GDP growth rates; rise in real interest rates; decline in revenues as a result of tariff reform (e.g., the EU Agreement) or decline in total output; assumption of contingent liabilities (e.g., the banking system, social insurance, quasi-government activities, and guarantees to the private sector) and increased government investment spending. Each of these risks can jeopardize the fiscal success that the GOE achieved in the early 1990s and a combination of more than one of these risks can adversely affect fiscal sustainability in Egypt. These concerns all argue for a stronger and a more coherent deficit reduction strategy.

Table AI.1.1: Illustrative Scenarios for Fiscal Sustainability in Egypt 2000-2009

Scenarios	Potential Cause of Change	Difference in Debt/GDP from the Base Scenario (p. p.)		Difference in Budget Balance /GDP from the Base Scenario (p. p.)	
		2004	2009	2004	2009
1. BASE LINE SCENARIO	----	**0.0**	**0.0**	**0.0**	**0.0**
2. GDP Growth:	External shocks and/or change in domestic policies				
Lower to 4.5%		6.2	11.9	0.5	0.9
Higher to 6.5%		-1.9	-3.6	-0.1	-0.3
3. Domestic Interest Rate: Rise by 2 p.p.	Liberalization of financial sector; expansion of private sector, etc..	6.7	13.8	1.8	2.4
4. Govt. Revenues/GDP:	Tariff reforms, regional agreements (e.g., EU), low oil prices, decline in Suez Canal revenues, etc.				
Decline by 1 p.p.		5.5	11.2	1.5	1.9
Decline by 3 p.p.		16.4	33.9	4.4	5.9
5. Govt. Spending/GDP:	Increased spending on social services, rapid spending on Mega projects, assumption of contingent liabilities, etc.				
Rise by 1 p.p.		5.5	11.2	1.5	1.9
Rise by 3 p.p.		16.4	33.9	4.4	5.9
6. Currency Devaluation: Annual by 5%		6.6	11.9	1.7	1.8
7. Increase in Government spending/GDP by 1 p.p. and decline in Government Revenues/GDP by 1 p.p.	Scenarios 4 and 5.	11	22.5	3.0	3.9
8. Increase in Govt. Spending/GDP by 2 p.p. and increase in domestic interest rates by 1 p.p.	Scenarios 3 and 5.	14.5	33.4	3.9	5.4

p.p. : percentage point.
Source: Staff simulations.

Annex I.2

External Sustainability Analysis[89]

AI.2.1. The external environment facing Egypt is changing rapidly. In addition to being a member of the World Trade Organization (WTO), Egypt has made progress in trade liberalization and has signed or negotiated trade agreements with COMESA, GAFTA and the EU to accelerate its integration into the world economy. These moves will intensify competition to domestic producers (particularly in the manufacturing sector) and may exert a negative impact on the trade deficit.

AI.2.2. Egypt's sources of foreign exchange are vulnerable to external shocks. Tourism is vulnerable to competition from other countries in the region and to domestic security developments (as was the case in late 1997). Workers remittances and foreign aid are also vulnerable to political and economic developments in the MENA region. Suez Canal dues depend on competition from other routes and means of transportation and on political developments in the region. International markets determine proceeds from oil exports and foreign investments have proven to be volatile in Egypt and other developing countries. The country's current intention to borrow from international capital markets will also expose Egypt to the volatility of international capital markets. Despite these vulnerabilities, Egypt's external debt and current account are sustainable and its international reserves are adequate. The above factors, however, call for the adoption of a strategy to address macroeconomic vulnerabilities and to strengthen further Egypt's external sustainability in the medium- and long-terms.

External Debt

AI.2.3. As indicated above, Egypt's total external debt remains relatively low. Debt figures imply fairly healthy debt statistics from the point of view of external vulnerability. In comparison with other similar middle income countries, particularly in the MENA region, Egypt is a moderately indebted country. The ratio of debt service to exports (9.5 percent in 1998) is less than half the level in the middle-income countries and significantly lower than that for the MENA region. Similarly, debt services to GNP ratio (2.1 percent in 1998) is more than half the prevailing levels in the middle-income countries and the MENA region. In net present value, Egypt's external debt outstanding at end 1998 represented 128 percent of exports of goods and services, and 28.6 percent of GNP. This compares well with ratios in other regions and similar countries.

AI.2.4. During 1991-2000, annual average net borrowing has been about US$ 339 million. With Egypt's graduation from the ranks of low-income countries, the structure, concessionality and maturity of its external debt have somewhat changed. The structure has changed in the late 1990s with less long- and medium-term loans in favor of more short-term suppliers' credits. During 1991-1995, net medium- and long-term loans average US$ 336 million per annum. However, starting in 1996, Egypt's repayments have exceeded drawings and the net external medium- and long-term borrowing became negative. Since 1992, Egypt also repaid more than its drawings of medium-term suppliers' credit. Egypt relied more on short-term suppliers' credit in 1994 and subsequent years with a net annual flow of US$ 0.64 billion during 1994-2000. Accordingly, the percentage of concessional debt in total external debt which exceeded 60 percent in 1989 continued to decline in the 1990s reaching only 12 percent in 2000. In 1998, 14 percent of total external debt was from multilateral creditors, 73 percent from bilateral creditors and 3 percent from private creditors and the remainder was short-term debt.

[89] All years fiscal years unless noted otherwise.

AI.2.5. Vulnerability indicators – such as the ratios of reserves-to-short-term debt and reserves-to-M2 – are still comfortable though they deteriorated markedly in the late 1990s. Reserves continue to be adequate, short-term debt is relatively low, and external debt is sustainable. Reserves to short-term ratio declined from 13.2 in 1997 to 9.3 by end 2000. Similarly, the reserves-to-M2 ratio declined from 0.36 in 1997 to 0.204 by end 2000 (and further to 0.196 in July 2000).[90] Furthermore, risk of sudden capital flight is minimal because of adequacy of reserves and restrictions on capital outflows.

Trade Concentration and the Balance of Payments

AI.2.6. With regard to market concentration for exports, Egypt decreased its reliance on EU markets and has expanded the coverage of its trading partners. In the last decade, the share of the EU decreased from 59 percent to 48 percent, the share of the US increased from 9 percent to 13 percent and regional trade strengthened with the share of the MENA sub-region doubling from 6 percent to 12 percent.

AI.2.7. As indicated in section II, the balance of payments has been under pressure since early 1998. The current account swung significantly from a surplus in 1997 to a deficit equivalent to 3 percent of GDP in 1998; the deficit continued into 1999 (2 percent of GDP) and 2000 (1.2 percent of GDP). The increase in imports has also been associated with the rising demand for producer goods as private investment is picking up. In 2000 and the first quarter of 2001, the capital account also showed a significant deficit mainly because of increase in the banking system foreign assets and other non-quantified outflows.

AI.2.8. The deficit in the overall BOP in 2000 took place despite improvements in oil prices, tourism revenues and investment flows. While it is difficult to project BOP trends, the situation in Egypt is even more difficult because of increased reliance on exogenous sources of foreign earnings that are highly susceptible to external shocks. Oil exports, Suez Canal dues, tourism revenues, foreign grants and workers remittances constituted 52 percent of total exchange earnings during 1991-1999. Reliance on these sources did not decrease in recent years and in 2000, the five items still constitute more than half of total foreign exchange earnings.

AI.2.9. In 2001 and beyond, the deficit in the trade balance may widen unless major policy changes to boost exports are implemented including the management of the exchange rate. The GOE has recently begun to allow a gradual depreciation of the exchange rate. The prospects for Suez Canal Authority dues look weak. They have been constant in US dollar terms and have fallen as a share of GDP from 4.6 percent in 1991 to 1.9 percent in 1900. The stagnation is attributed to competition from pipelines, the land route and the Cape route. Many of the large vessels also cannot pass through the Canal. Egypt's tourism potentials are enormous. However, the sector depends mainly on developments in the security situation and also on increasing competition from countries in the region. The year 2000 has seen recovery in tourist revenues exceeding the pre-Luxor levels. Reliance on unrequited transfers will be limited, particularly workers remittances, by projected lower demand for Egyptian labor from regional markets.

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90 The IMF (2000), however, show that data of the Bank of International Settlement (BIS) provides for higher levels of short-term and private sector debt than official data. BIS data indicates that as of end-September 1999 the total private and short-term liabilities of Egypt to banks were US$ 7.2 billion whereas the data presented by the Egyptian authorities show a total of US$ 2.3 billion. Even on the basis of BIS data, the ratio of reserves to short-term debt remains comfortable (at about 200 percent).

AI.2.10. With regard to the capital and financial account, tighter financial policies and an attractive pipeline of privatization offerings (e.g., telecom and electricity) are expected to contribute to a modest recovery in portfolio and other capital inflows. As a whole, Egypt does not seem to face a short-term risk of a BOP crisis since reserves continue to be adequate, short-term debt is relatively low, and external debt is sustainable. Tight monetary and fiscal policy currently pursued by the GOE – in addition to gradual depreciation of the exchange rate – will improve the external balances.

Table AI.2: Egypt's External Debt and Debt Service, 1988-1998

	1988	1990	1992	1994	1995	1996	1997	1998
Total External Debt (current US$)	46084	32947	31066	32314	33266	31300	29850	31964
Total debt service (current US$)	2468	3071	2701	2240	2379	2283	1928	1813
Total debt service (% of GNP)	7.1	7.3	6.7	4.4	4.0	3.4	2.5	2.1
Total debt service (% of exports of goods and services)	22.0	22.5	15.9	14.9	13.4	12.7	9.7	9.5
Short-term debt (% of total external debt)	14.9	13.5	8.1	6.0	7.1	7.5	10.0	13.3

Source: World Bank, World Development Indicators, 2000.

Annex Tables for Chapter I

Table AI.1: Factors Contribution to GDP Growth in Egypt, 1965-2000

Year	Growth Rate (%)			Contribution to GDP Growth (%)		
	GDP	Human Capital Adjusted Labor	Physical Capital	Human Capital-Adjusted Labor	Physical Capital	TFP
1965-1970	3.33	3.29	3.80	1.74	1.79	-0.20
1970-1975	3.48	3.04	6.24	1.61	2.93	-1.06
1975-1980	9.80	4.07	13.54	2.16	6.36	1.28
1980-1985	6.73	2.42	11.89	1.28	5.59	-0.14
1985-1990	4.22	3.37	6.45	1.78	3.03	-0.59
1990-1995	3.39	3.64	3.73	1.93	1.75	-0.29
1995-2000	5.72	4.65	6.88	2.47	3.23	0.02
1965-2000	**5.22**	**3.50**	**7.45**	**1.85**	**3.50**	**-0.13**

Source: Staff calculations
Note: TFP indicates total factor productivity.