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ECONOMIC REFORM

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ECONOMIC REFORM

I. INTRODUCTION

The economic transition on which Egypt has embarked is intended to get the economy onto a path of real economic growth that exceeds the population growth rate, and that can be sustained over the long run without concessional external assistance. A broad consensus has been reached among the GOE and its principal donors that this goal can only be reached by converting the economy to one directed by competitive private market forces, expressed through a system of market-determined prices, costs, and rates of return, and by integrating Egypt into the international economic mainstream.

The transition will be difficult. It will involve contraction and even closure of enterprises and loss of jobs. It will involve changes in what is produced, how, and where. Inefficient farms and factories and their workers will experience declining incomes. In anticipation of these costs of adjustment, a Social Fund has been created to provide a "safety net". The importance of this fund operating effectively would be hard to exaggerate, as it may be the "shock absorber" that prevents derailment of the economic program by socio-political turmoil.

To reach the growth objective, four fundamental conditions will have to be satisfied. First, the existing economic system will have to be subjected to competitive market tests of efficiency. Firms and enterprises that cannot sell their products at market-determined prices, and cover market-determined costs, will have to close down so that efficient firms can start and expand operations. This will ammost certainly mean that the public sector share of production will decline while the private sector share expands. Only in this way can it be assured that the directions of growth are consistent with efficient resource use.

Next, new private investment and domestic saving will have to be undertaken at rates that are unprecedented in recent history. One-fifth or more of GDP will be required for the formation and replacement of productive capacity in each of the next few years, rising to one-fourth of GDP for the last half of the decade. Of this amount half will need to be private investment, which implies a near doubling of recent rates. (During the second half of the 1980s, private investment drifted upward from 5.8 percent of GDP to 6.6 percent. Over the next five years, it will have to approach 12 percent in order to nudge the GDP growth rate gradually up to the 4 to 5 percent range.)

To mobilize the extra resources required to finance investment at rates of 20 to 25 percent of GDP will require a herculean effort to stimulate savings. Egypt's domestic savings seldom exceed 10 percent of income, as 90 percent or more is customarily spent on comsumption. Foreign savings of up to 10 percent of GDP have at times been available, but the nation cannot, and should not, depend indefinitely on this much foreign finance. Foreign lending becomes foreign debt, and foreign grants become dependency. Thus conditions must be established that induce Egyptians to increase their saving sharply, and to lodge their savings in Egypt. Domestic savings rising from 15 to 18 percent of GDP will probably be required in this decade to finance the investment needed to reach GDP growth of 4 to 5 percent. This implies an improvement over 1991-92 savings performance of $2 to $3 billion annually.

A third necessary condition for reaching the desired growth path is the establishment of an enlarged and stable flow of earned foreign exchange. Virtually all goods and services produced in Egypt contain some imported inputs and rely on foreign technology. Foreign goods and technology must be paid for in foreign exchange, and official grants and concessional loans are not dependable.

During the 1980s, exports of goods and non-factor services averaged only about 20 percent of GDP while imports averaged almost 50 percent. In the 1990s, that gap must be narrowed with exports advancing to 25 percent and imports receding to 35 percent. While these results are attainable, they will not be reached without supporting policy reform. Merchandise exports, for example, would need to grow at an annual rate of 8 percent or better throughout the period. If local production costs continue to rise and the exchange rate remains stable, this target rate of export growth probably is out of the question. Similarly, if regulatory and administrative obstacles to the private sector are not removed, the goal is unlikely to be reached regardless of exchange rate policy.

The fourth condition that must be met is the adequate provision of those public sector services and infrastructure needed to complement private facilities, along with a better balance between government expenditures and tax collections. Over the past decade, government expenditures have exceeded revenues by an extraordinary 20 percent of GDP on average. A public sector financing requirement of this magnitude far exceeds domestic saving, and "crowds out" private investment. The GOE has made progress toward reducing the deficit, but a more productive and more elastic tax system will be required to assure that it continues to decline and remains at a prudent rate. Realistically, Egypt cannot be expected to administer effectively a complicated system of taxation such as the one now in place. (Outstanding uncollected balances due at present are estimated at about ten years of actual collections, on the income tax alone.)

While trimming the public sector budget deficit is an important component of this condition it is not the only component. Even as the Egyptian economy becomes more market-oriented, there will be a continuing need for public services and infrastructure that complement the free market economy. Identification of these public goods requirements calls for careful selection, evaluation and management of public expenditure programs. On the tax side, the way citizens are taxed is as important as the amount they are taxed. It is important that the potential gains from the shift to a market economy are not compromised by inordinate or unintended tax system distortions.

To summarize, four ingredients are required to launch Egypt onto a growth trajectory that promises steady improvement in living standards and a phasing in of self sufficiency:

1. An internationally open system of competitive private markets directed by market prices, costs and rates of return.

2. Significant increases in private saving and investment.

3. A large and reliable flow of foreign exchange earnings.

4. A system of government expenditures that provides the public services and infrastructure required to complement the market-directed private sector, and a tax system that: (a) generates sufficient revenue to permit responsible, dependable financing for public goods; (b) is fair; and (c) does not distort the structure of economic activity.

The first step toward the realization of the foregoing conditions is to restore financial stability. The fundamental measures of stability are the rate and predictability of changes in averages of commodity prices, wages, interest rates and exchange rates, and the rate of accumulation of national productive wealth (including productive capacity, foreign exchange and inventories, primarily.) These variables are most importantly influenced by the way public financial management (i.e., fiscal and monetary policy) is conducted. The policy and regulatory environment of the financial sector is the key determinant of the speed and degree to which stability can be attained.

It is fitting therefore that Egypt launched its program of comprehensive economic reform by reaching agreement with the International Monetary Fund (IMF) on a Stand-by Arrangement targeted directly on stability. Specific quantitative limits were set on banking system credit to the public sector as well as on aggregate credit expansion. Limits were also placed on external debt, and a tough target level of international reserves accumulation was set. At the same time, monetary expansion was being brought under more disciplined control, the foreign exchange market and the exchange rate were completely freed up, and interest rates were subjected to market determination through elimination of controls on bank interest rates and establishment of an auction market for Treasury Bills.

The sheer magnitude of the transition from centrally controlled economy to competitive market economy in Egypt makes it clear that a firm-by-firm or even industry-by-industry effort to correct distortions could not succeed. Neither the GOE nor any donor or group of donors has sufficient resources to undertake such a task. Instead, the approach must be to establish and enforce a set of market-based "rules of the game" that govern all firms, regardless of the industry or sector, and that assure that the efficient can prosper and grow while the inefficient cease or contract operations.

USAID was the first major donor to recognize the necessity of the broad, policy-intensive approach to economic restructuring. This is reflected in sector-wide programs in traditional productive sectors. The policy reform components of projects in the Agricultural and Energy sectors have been particularly effective. Policy reform efforts in these productive sectors are treated in the Strategy Annexes of those sectors.

However, the first formal program the GOE entered with a donor to implement structural adjustment as part of a comprehensive effort was the Structural Adjustment Loan (SAL) with the World Bank. Under that program the GOE agreed to a myriad of policy, regulatory and institutional reforms designed to begin the arduous process of eliminating not only the uneconomic distortions, but the "rules of the game" that brought them about in the first place. Under this program, the government planned seven specific areas of reform, as follows:

1. Macroeconomic reforms intended to stimulate increased savings and investment, improved balance between government spending and revenue collections, and improved balance between exports and imports.

2. Financial sector reforms to impose a binding financial constraint on all enterprises, and to begin to restore solvency to the banking system as well as to encourage broader and deeper financial sector development.

3. Public enterprise reforms to turn production over to private enterprises and to govern the level and structure of economic activity by market tests of efficiency.

4. Public policy reforms aimed at greatly reducing the unnecessary controls, regulations and restrictions imposed on the private sector.

5. Price liberalization to eliminate excess consumption of subsidized goods and deficient production in other areas.

6. Foreign Trade liberalization to facilitate competition and efficiency.

7. A Social Fund to provide a "safety net" to protect the most vulnerable and defenseless segments of the population.

Substantial progress has been made in each of these areas, though not enough so that the wholesale structural changes that are expected have begun to appear. Most price controls have been removed, but those that have not are important. Marketing controls on many crops have been eased or eliminated, but those on the key crops (cotton, specifically) remain. Target capital adequacy ratios for banks have been set, but not yet reached. The formal process for investment approvals has been liberalized, yet de facto restrictions reportedly remain. Import restrictions and export obstacles have been eased, but again, the most important ones remain.

Thus there is progress, but the really tough areas, such as privatization of public enterprises, lag, and hence obstruct the achievement of major, observable private market dynamism. For this reason, the Mission has designed a Sector Policy Adjustment Grant (SPAG) to reinforce and complement the GOE/World Bank SAL. The SPAG focuses on the fundamental functional sectors (Finance, Fiscal, International Trade, and Domestic Enterprise).

All economic activity in Egypt is influenced by policy governing transactions among economic agents in each of these domains. Thus the schema satisfies the need to concentrate limited economic assistance resources in areas of the broadest possible impact. We turn now to a brief description of each of these functional sectors (as opposed to productive sectors of Agriculture, Manufacturing and Services) and a discussion of the specific impediments to economic efficiency and growth that each sector's policy reform agenda seeks to remove.

II. FINANCIAL SECTOR

In a market economy the financial sector has four basic functions to perform: (1) It provides the mechanism for making payments in settlement of accounts (the banking system); (2) it provides an attractive abode for the savings of a wide variety of savers with diverse risk, return and liquidity requirements, and a source of financing for the establishment or expansion of productive capacity (i.e., investment); (3) it allocates savings among competing investors on the basis of efficiency; (4) it provides instruments for managing and hedging normal market risks.

These four functions could be condensed into two--providing a payments mechanism and stimulating and intermediating savings and investment. For many years, deterioration of the porftolios of Egypt's commercial banks has been placing the payments mechanism in increasing jeopardy. Since reaching agreement with the IMF on a Standby arrangement, the GOE has, with IMF help, taken important measures to recapitalize the banks and to avoid similar deterioration in the future. The Basle standards for monitoring and classifying bank assets have been adopted and tough provisioning requirements for non-performing assets have been imposed. A strict 8 percent capital adequacy ratio is being phased in, and the old practice of forcing continuously growing, uneconomic credit extensions to public sector enterprises will eventually be abandoned.

As the new measures begin to take hold, the banks' assets will come more into line with their deposits. Individual wealth owners may be expected to become more willing to place funds in local banks and other financial institutions as the institutions become more financially sound. Thus in addition to strengthening the payments mechanism, these measures will increase the appeal of Egyptian institutions as abodes for savings.

The IMF, the World Bank and AID all have focused both dialogue and programs on the need to increase the level of domestic savings and, simultaneously, to eliminate structural distortions that interfere with the application of savings to investment projects offering the greatest possible economic returns. To this end, all three institutions are working with the GOE toward early elimination of of government interference in the establishment of interest rates, tax laws that force the adoption of economically inappropriate debt/equity financing strategies, and policy, legal and regulatory barriers to the establishment of a dynamic private securities markets and to the development of a full range of financial assets, instruments and institutions.

The Sector Policy Adjustment Grant, now under negotiation with the GOE, seeks to assist the Government in identifying the specific steps that must be taken to realize the broader financial sector objectives of the SAL and the GOE's own Economic Recovery and Structural Adjustment Program (ERSAP). Our analysis of the sector in this context is the subject of this section.

A. Analysis of Sector

Banking is dominated by four public sector commercial banks (PSCBs), which hold about 65 percent of total deposits at present. Before 1975, each PSCB provided credit to a separate sector of the economy. In 1975, this system was abolished and new banks were allowed to be established. To date there are 44 commercial banks, including the PSCBs, 33 business and investment banks (11 joint ventures and 22 foreign branches), and 4 specialized banks for a total of 81 banks. PSCBs and government entities have ownership in many of the joint venture commercial, business, and investment banks. Thus a pro-public sector bias must be presumed to remain.

Interest rate ceilings in the banking system existed until early 1991. These ceilings were imposed by the Central Bank on borrowing and lending in local currency. Nominal interest rates were fixed below the inflation rate, resulting in negative real returns. At the same time, interest rates on foreign currency deposits were flexibly based on international markets and yielded positive returns. This real interest rate differential encouraged Egyptian residents to hold a disproportionate share of their assets in foreign currency deposits.

Non-bank Islamic investment companies evolved in the mid 1980s in response to the distortions in interest rates and the inefficiencies in the financial sector. These companies provided interest rates ranging from 20 to 25 percent, and they succeeded in mobilizing significant volumes of deposits. In addition, Islamic investment companies rendered foreign exchange transfer services at lower transactions cost than the banking system. Due to mismanagement and perhaps even fraud, this system collapsed in 1987. Nevertheless, they taught one important economic lesson--Egyptian savers respond positively to interest rate incentives.

Distortions in interest rates had wide repercussions. Preferential interest rates to certain sectors of the economy and to the public sector in general, distorted resource allocation in the economy. Industry and agriculture got the most concessional interest rates--not exceeding 17 percent. Loans and overdraft facilities to public sector enterprises were also available at concessional interest rates (7-11 percent). Lending to public sector enterprises not only crowded out private investment but led to the erosion of banks' capital as this lending was mostly to loss-making enterprises at negative real rates.

Policy changes aiming at the correction of distortions in interest rates were introduced by the Central Bank in January 1991. The government liberalized most interest rates and introduced a Treasury bill market as the centerpiece of a system of market based interest rates. This resulted in higher, more competitive interest rates, although real interest rates may still be negative.

Higher rates on deposits have encouraged the holding of LE deposits. Reinforced by the stability of the now free-market exchange rate, a repatriation of savings from off-shore accounts has been another response. Lending rates that more nearly reflect the real cost of capital, particularly with the elimination of the preferential rates to targeted sectors and to the government, are expected to lead to a more competitive, and hence more productive allocation of credit.

Improving prudential regulations and strengthening banks' capital structure is a key element in the financial reform program. Recapitalization of the four public sector banks began in 1991. The Central Bank of Egypt issued a circular in January 1991 regulating bank capital adequacy along the Basle risk-weighted guidelines, and implemented, by July, a system for classification and provisioning of banks' assets.

The Central Bank's control over the money supply was not effective until 1991. During the past 5 years, the average annualgrowth rate of the money supply was about 25 percent, compared to only 2.5 percent GDP growth. The discontinuation of overdrafts by the Ministry of Finance and the introduction of the T-Bill market in 1991, have significantly improved monetary management. Nevertheless, policy instruments available to the Central Bank are not yet sufficient. Devlopment of a secondary market for securities would permit more efficient open market operations. A stronger banking system would permit more effective use of reserve requirement adjustments. Both issues will be addressed as part of the SPAG.

On the capital market side, the securities market is still underdeveloped and inactive. The total market value of listed securities was about 6 percent of GDP in 1990. Most listed companies are closed companies and thus their shares are neither available to the public nor traded. Corporate bonds are almost non-existent because of the statutory 7-percent interest rate ceiling imposed on them under the civil code.

B. Barriers and Constraints to Growth and Development

Despite the efforts made to reform the monetary system, efficient allocation of financial resources is still adversely affected by the existence of a set of distorted interest rates. These include: the interest rate charged on loans extended by the Housing Bank to finance low-income housing, and for refinancing of export credit; the interest rate paid by the CBE on deposits (including but not limited to, reserve deposits.); the interest rate charged by the National Investment Bank on its loans to the housing sector, which is about 6 percent; and the interest rate on strategic projects, such as food security and land reclamation.

The growth of a safe and stable financial system depends, inter alia, on banks' capital adequacy levels. In early 1991, recapitalization of the four PSCBs started. As a result of the long-existing system of administrative allocations of credit by sectors, overdraft facilities to loss-making public sector companies, and negative real interest rates, the level of non-performing assets on banks' balance sheets adversely affected their solvency. Under the IMF agreement, banks should reach the 8-percent target for the capital adequacy ratio by end-1993. So far, they have not reached the target. Thus the absence of adequate capital persists as a barrier to the stability of the financial system.

Barriers to free entry serve to limit competition in the banking system and hinder the efficient allocation of financial resources. The resulting domination by public sector banks can affect market interest rates, through the Treasury bill rates. In addition, PSCBs do not provide the wide range of financial services which can reduce transactions cost and increase efficiency of the financial system. Moreover, PSCBs still receive preferential treatment on branching. Public sector banks need to get approval only from the CBE, while other banks need approval from both the CBE and the investment authority. This, in effect, reduces competition in the market.

Private sector participation in the banking industry is restricted by PSCBs ownership in many of commercial, business, and investment banks. Such ownership limits the banking sector's access to the better expertise and management associated with the private sector.

About 22 foreign banks currently operate in Egypt. However, current laws and regulations do not allow them to operate in local currency. For a bank to operate in local currency, foreign ownership must not exceed 49 percent. This deprives the banking system and the money market of the expertise which such banks bring with them and thus reduces competition and efficiency in the sector.

The activation of the capital market still faces a number of barriers. Inequitable tax treatment of financial instruments and institutions is a major constraint. Bank deposits and the relevant interest are tax exempt. Securities, on the other hand, are subject to a number of taxes including the annual stamp duty, and the taxes on mobile capital revenue, general income, and corporate income. The appropriate development of the securities market in Egypt is impeded by this uneven tax treatment.

Debt instruments are subject to a statutory 7-percent ceiling imposed on interest paid on corporate bonds or other debt instruments. This ceiling has become obsolete in the liberalized financial market and the market rate on "T-Bills" which is in the range of 17 percent to 19 percent. With the liberalization of interest rates and the crucial need to develop and activate the capital market, abolishing the statutory 7-percent ceiling is both inevitable and desirable.

The growth of non-bank financial institutions is currently stifled by various laws and regulations. Fund Receiving Companies (FRCs), essentially Mutual Funds (MFs), are subject to double taxation of their distributed earnings. Corporations are taxed for capital gains realized on securities, while individuals are not.

Existing legislation allows corporations to establish corporate pension funds, but effectively assures that they will not become significant components of the private financial system. The legislation provides that 1 percent of the revenues of a private pension fund (both subscriptions and investment income) must be paid to the Ministry of Social Affairs, and that 50 percent of a Fund's assets must be deposited with the National Development Bank.

The brokerage commission structure discourages dealing in securities. High fixed brokerage commissions increase capital markets transactions costs. The commission structure--1 percent for shares, and 0.4 percent for bonds--is high by international standards. It is advisable to leave commissions negotiable rather than fixed.

Standardized accounting practices and auditing standards are deficient, diverse, and do not provide consistent information to investors. With USAID financial support, the Accountants and Auditors Institute have formulated a revised set of standards. The real barrier is the enforcement of the revised practices and standards. It is suggested that the unified law governing the operations of a private sector securities market enforce such practices and standards, and other disclosure requirements for listed companies.

Other financial sector distortions are the legal requirements imposed by the Central Bank for registration of loan collateral and court restrictions on taking possession of collateral in the event of loan default. These policies have negatively affected the profitability and financial soundness of many banks, leading to greater outstanding bad debts and lower capital levels.

C. Strategy for Addressing Constraints

The USAID policy program's conditionality in the financial sector concentrates on establishing a number of benchmarks which focus on:

- o increasing private sector participation, both domestic and foreign, in the banking system;
- o removing remaining interest rate distortions;
- o passing a new securities market law;
- o achieving equitable treatment for all financial instruments; and
- o strengthening banks' capital structure.

The USAID policy program in the financial sector will require contributions from, and coordination of efforts among, three entities which are responsible for different elements of the financial sector program. However, in view of the weaknesses in administrative coordination among these entities, the financial sector program is likely to be divided into three components to deal, respectively, with:

1. the banking system (Central Bank);
2. the legal and regulatory framework for capital markets (Ministry of Economy); and
3. correction of tax disparities among financial instruments and institutions (Ministry of Finance).

III. FISCAL SECTOR (GOVERNMENT REVENUES AND EXPENDITURES)

A. Analysis of Sector

Sector Role. Egypt's fiscal sector has a key role to play if the economy is to achieve sustained growth in real per capita income. Such growth requires macroeconomic stability in order to control inflation, encourage savings and investment, and maintain external creditworthiness. This, in turn, depends on fiscal policies that combine an elastic tax structure with a restrained expenditure policy which effectively complements a growing private sectgor. The fiscal sector must also help ensure that private sector resources are used where they are most productive. Collecting taxes in ways that do not seriously distort market prices will permit markets to operate more freely--with efficiency gains (and cost savings) in domestic markets and greater competitiveness (and foreign exchange earnings) in world markets.

Revenues. Preliminary data for FY 1990/91 indicate that total GOE revenues increased by 40 percent over the previous year, reaching 29 percent of GDP. About 65 percent (LE 15.5 billion) of central government revenues came from tax sources, with the balance (LE 8.1) from non-tax sources. Direct income taxes accounted for 45 percent (LE 6.9 billion) of tax revenues, while indirect taxes accounted for 55 percent. Non-tax revenues result from the transferred profits of public authorities (mainly petroleum, the Central Bank, and the Suez Canal) and public sector companies. Public authorities and companies accounted for 70 percent of non-tax revenues in 1990/91.

The increase in 1990/91 revenues was largely accounted for by: the implementation of the general sales tax in May 1991 ("consumption" tax prior to May 1991); restoration of customs duties to their pre-July 1989 rates; increases in energy and tobacco prices and taxes; higher fees, charges and railway fares; and the full and timely transfer of taxes and profits from the Suez Canal and the petroleum authority.

Although total GOE revenues more than tripled between 1981/82 and 1990/91, they declined as a proportion of GDP. This inelasticity with respect to income is a condition that must be remedied before the fiscal system can contribute to general financial stability and indeed to economic growth. Thus tax reform is again indicated as a necessary condition for the kind of stable growth path sought.

The structure of the increases in tax collections that have occurred over the last decade betrays inordinate reliance on indirect taxes in general (over one-half of all increased taxes) and on taxes on tradeable goods (over half of the total). The consumption/sales tax, customs duties, and stamp taxes accounted for 23, 16, and 11 percent of the overall increase in tax revenues, respectively. Half of the sales tax is levied against imports. Direct income taxes accounted for the remaining 48 percent of the tax revenue increase.

Expenditures. Over the last decade, nominal GOE expenditures grew at an average annual rate of 13 percent, although in real terms they fell by about 5 percent annually. Preliminary actual data for 1990/91 indicate that total expenditures reached LE 48 billion or about 49 percent of GDP (at current prices). The shares of current and investment expenditures in total GOE expenditures have remained fairly constant at about 62 and 38 percent, respectively, over the last decade.

Wages, subsidies, defense and interest on public debt account for about 20 percent each, on average, of current expenditures. Debt interest payments have increased more than fourteenfold between 1981/82 and 1990/91 as foreign obligations and unpaid arrears of the GOE reached an estimated US$ 45 billion by early 1990. Their share in current expenditures increased from 6 to 24 percent in this period.

About 44 percent of investment expenditures were directed to the economic services sector over the last decade, while 39 and 17 percent went to the non-financial public enterprise and the social services sector, respectively. The economic services sector includes transport and communications, electricity and agriculture, which account for about 14, 13, and 6 percent, respectively, of public sector investment expenditure. Housing was the principal element in the social services sector accounting for 13 percent of total investment expenditures.

The Budget Deficit. In recent years, Egypt's fiscal deficit has reached levels that are inconsistent with sustained growth and stability. It peaked in 1981/82 at about 24 percent of GDP in 1981/82, dropped briefly to 18 percent in 1986/87, and rose again to about 20 percent in 1990/91. The GOE is committed to reduce the overall fiscal deficit to no more than 9.5 percent of GDP in 1991/92, no more than 6.5 percent of GDP in 1992/93, and to reach a level of no more than 3.5 percent of GDP by 1995/96.

As in most developing countries, due to the absense of well developed securities markets, the main source for financing the Egyptian budget deficit for the past decade has been borrowing from the banking system, including the central bank. Bank finance has accounted for half of total finance, on average. For the GOE budget year 1990/91, however, preliminary data show that domestic bank financing of the deficit dropped to LE 1.6 billion or 8 percent of total finance. This is down from LE 7.7 billion or 26 percent of total finance in 1989/90.

Heavy borrowing from the banking sector was a major contributor to price inflation in the late 1980s. Thus the recent improvements augur well for stability. There has also been improvement since the Gulf Crisis that could indicate a future easing of the degree to which non-bank domestic finance of the budget "crowds out" the private sector. This source of domestic finance (which includes pensions and social insurance, post office savings, self-financing surplus, and government bonds) accounted, on average, for 79 percent of total deficit financing, while financing based on inflows of hard currency was only 21 percent. After the Gulf crisis, the share of external finance in total finance increased significantly from 21 percent in 1989/90 to 73 percent in 1990/91. While this has offered relief from both inflationary and "crowding out" effects of deficit finance, it must be viewed as transitory (at least in the grant and debt forgiveness elements). It offers breathing space in which tax reform can address the fundamental weaknesses described above.

B. Barriers and Constraints to Growth and Development

Fiscal revenues in Egypt tend to be unstable due to their heavy dependence on the external sector. Suez Canal earnings and oil revenues are highly sensitive to changing external circumstances. Adverse external circumstances thus impact directly and substantially on government revenues, in addition to their indirect effects on the general level of economic activity and consequently on other tax revenues.

As noted above, the tax system as a whole is characterized by relatively low revenue elasticity. The present schedular income taxes combine the undesirable features of high marginal tax rates with eroded bases. The latter is due to tax avoidance and evasion, various tax holidays, and the vulnerability of tax revenues to inflation due to both the long lags between assessment and collection of taxes, and the inadequate penalties applied to delayed payments. In addition, customs receipts are limited by a tariff structure with many specific tax rates and the widespread use of exemptions.

The tax system is complex, costly to administer, and inefficient. The complex structure of income, property and inheritance taxes creates high costs of administration and compliance, both complicating administration and virtually guaranteeing continued poor compliance. Indirect taxes, such as the development duty and the social solidarity tax, are often levied on bases which overlap with those for other taxes, thereby increasing both the compliance and the administrative cost of the tax system.

The wide variation in tax rates on different types of income, together with the wide range of customs duties on various types of imports, introduce significant economic distortions in the economy which distort the allocation of resources. Moreover, the structure of the tax system, together with uneven compliance and enforcement, do little to ensure horizontal and vertical equity.

C. Strategy for Addressing Constraints

The success of the GOE's economic reform program depends critically on both the attainment of macroeconomic stability and the reduction of distortions in the economy which cause resources to be used inefficiently. Tax reform can play a key role in both stabilizing the economy and making it more efficient. Increased tax revenue generation will reduce the budget deficit--thereby damping inflationary pressures and freeing up resources for private sector investment. A tax system that is more nearly neutral with respect to decisions about what, how and where to produce will help channel resources where they can be used most productively--thereby promoting economic growth.

The GOE has already committed itself in broad terms to fiscal reform. The budget deficit is on track to be reduced, through expenditure restraint and resource mobilization, as targeted under the IMF Stand-by Agreement. On the tax side, the GOE is committed to the adoption of both a broad based sales tax, which will ultimately evolve into a full blown value added tax, and a global income tax to replace the series of schedular income taxes now in effect.

In this context, USAID policy conditionality in the fiscal sector will concentrate on establishing specific tax policy and expenditure benchmarks--the attainment of which will assist the GOE in meeting its broad fiscal sector commitments. These benchmarks will focus on:

- o broadening coverage of the sales tax;
- o detailing the structure of the global income tax;
- o limiting the growth of certain components of GOE expenditures;
- o assisting the GOE in developing the capacity to plan,monitor and execute its investment budget, and to forecast revenues and expenditures;
- o improving public access to GOE fiscal data.

IV. INTERNATIONAL TRADE SECTOR

Sustained growth in per capita income requires a large and reliable flow of foreign exchange earnings. To accomplish this, Egypt must make good use of its resources to compete effectively in world markets. This in turn requires macroeconomic stability, competitive domestic markets, and the public provision of necessary infrastructure and human capital skills. This is not enough, however. The trade sector itself must foster and permit Egypt's international competitiveness. Lowering import barriers will require or allow Egypt's domestic producers to become more efficient. Reduced export barriers will permit domestic efficiency gains to be translated into greater competitiveness in world markets. As described below, this has not been the case in Egypt during recent decades. While progress in liberalizing Egypt's trade regime has been made, significant barriers still exist.

A. Overview of the Sector:

General Description. Egypt's trade regime has, for four decades, been characterized by an import substitution strategy that placed little emphasis on export promotion. Nasser initiated a strong industrialization drive headed by the public sector in 1960. The government monopolized imports, and barter deals were introduced to exchange Egyptian goods for military imports. By the early 1970s, foreign exchange was scarce due to reduced foreign aid and increased military outlays. The economy was characterized by idle capacity and economic recession.

Egypt's 1974 Open Door Policy began to liberalize trade and foreign exchange practices. Receipts of foreign exchange surged on account of the boom in oil exports, increases in tourism revenues, and drastically higher Suez Canal earnings, workers' remittances and foreign aid. These new sources supported a real annual GDP growth rate of 9.5 percent between 1975 and 1983/84. Total current account receipts and transfers increased from $2.8 billion in 1975 to $12.5 billion in 1983/84. While oil exports increased from zero to $3.0 billion during this period, non-oil exports remained stagnant, in nominal terms, at $1.4 billion. Imports tripled from $3.6 billion in 1974 to $10.7 billion in 1983/84, thereby absorbing around 60 percent of the increase in foreign exchange receipts. Overall, the trade deficit increased from $1.8 billion in 1974 to $6.4 billion in 1983/84.

Failure to form a new, broader base of production and exports during the period of prosperity exacted a heavy toll when the inevitable reversal of favorable external conditions occurred in the later 1980's. Oil export revenues declined sharply from $4.2 billion in 1984/85 to $2.7 billion in 1988/89. Despite the fact that non-traditional exports increased by 221 percent between 1984/85 and 1989/90 (from $0.74 billion to $1.64 billion), and that imports remained roughly constant ($10.5 - $10.7 billion), the significant decrease in oil exports throughout the period resulted in an overall worsening of the trade deficit (from $6.3 billion in 84/85 to $7.6 billion in 1989/90).

Exports. In 1974, the major Egyptian exports were raw cotton,(36 percent), textiles (20 percent) and agricultural commodities (11 percent). Starting in 1975, however, oil became the principal export commodity while cotton and textiles declined in importance. With the fall in international oil prices in 1982/83, proceeds from oil exports decreased (see table 1). By 1989/90, oil exports constituted 39.8 percent of total exports--down from 68 percent in 1983/84.

Exports of cotton also declined from $356.1 million (10 percent of exports) in 1985/86 to $220 million in 1989/90 (7 percent of exports), as a result of the continuing government policy of suppressing cotton farmgate prices, even as world market prices advanced over 400 percent.

The major shift in the composition of exports in 1986/8789/90 was the significant growth (although from a very low base) of the value of non-traditional exports such as food processing (21 percent per year), chemicals and pharmaceutical (51 percent per year), wood products (109 percent per year), knitted products and garments (65 percent per year), iron & steel (134 percent per year) and aluminum (19 percent per year). The composition of exports in terms of the degree of processing also changed significantly. The share of primary commodities declined from 68 percent in 1986/87 to 50 percent in 1989/90. The share of semi-finished products remained roughly constant at 20 percent, while the relative importance of finished goods increased from 16 percent of total exports in 1986/87 to 29.5 percent in 1989/90.

Egypt's export performance in the 1980s demonstrates that the processes, procedures and institutions required to mount a successful export campaign, can be mobilized. Nevertheless, with the plethora of regulations, subsidies, and controls, one cannot feel confident that the export growth pattern made economic sense.

The public sector still monopolizes the export of petroleum, raw cotton, cotton yarn and alumina. The private sector domain is in the export of non-traditional goods such as food processing, pharmaceuticals, furniture, garments, and iron and steel and aluminium products. Rice recently switched from the public to the private sector. As policy reform proceeds, it will have to permit real economic conditions - labor's efficiency, Egypt's factor endowments, international scarcities and consumer tastes and preferences -- to sort out which export areas make sense for Egypt and which imply negative real returns.

Table 1
Composition of Exports
(US $ Million)

	1974	83/84	86/87	89/90
Total Exports:	1754	4350	2831	3145
-Oil	187	2957	1470	1229
-Cotton	663	452	343	220
-Other agricultural goods	194	211	124	187
-Other industrial of which:	710	730	894	1509
*Yarn	366	267	241	446
*Ready made garm.&other textile			28	189
*Chemicals & Pharmaceutical			95	248

Source: CBE & EAS estimates

<u>Imports.</u> Between 1974 and 1983/84, the total value of imports tripled from $3.6 billion to $10.7 billion (see table 2). The share of capital goods increased from 16 percent to 26 percent with the growth of new capital intensive investments, while the share of intermediate goods decreased from 42 percent to 34 percent of total imports. Although total imports declined between 1984/85 and 1986/87, they reverted to their 1983/84 level by 1989/90. One damaging consequence of the shift to capital and import -intensive production while policy discouraged export development, is that it holds domestic economic activity hostage to external conditions that Egypt cannot hope to control.

The public sector monopolizes the import of wheat, flour, edible oil, and cotton. Only recently was the private sector allowed to import fertilizer, sugar and tea. On average, the public sector imported around 75 percent of total imports between 1983/84 - 87/88.

Table 2
Composition of Imports

	1974	1983/84	86/87	89/90
Total Imports($ million)	3618	10738	7952	10773
(Percent Composition)				
-Foodstuff	29%	28%	25%	21%
-Intermediates	42%	34%	32%	38%
-Capital goods	16%	26%	23%	22%
-Other including grants	13%	12%	20%	19%
	100%	100%	100%	100%

Source: CBE

B. Barriers and Constraints to Growth and Development:

Export Restrictions. In June 1991, after reducing export bans from 20 to 6 items, export quotas from 17 to 4 items and prior government approvals from 37 to 1 item, production coverage of all non-trade barriers on exports was reduced from 11.9 percent to 4.2 percent of manufacturing and agricultural output. The impact was essentially equal on the private and public sectors, with a reduction of 65 percent for the latter and 67 percent for the former. In September, three additional commodities were lifted from the banned list (oil seeds, rice straw and raw skins). In addition to the non-tariff barriers on exports, a system of implicit and explicit export taxes characterizes the export sector, e.g. the below market price at which cotton producers must sell their crop to the government.

Drawback and Temporary Admission Systems. Exporters who use imported raw materials can benefit from either the drawback or the temporary admission system, provided they export the finished product within one year from the importation of the raw materials. Under the drawback system, exporters have to pay the custom duties and sales tax but are entitled to claim them back upon exportation of the final product. Under the temporary admission system, however, exporters have two privileges. First, they can import banned commodities for the production of exported goods. Second, they need not pay duties and sales tax on regularly imported materials. Instead, private sector firms submit a cash or bank guarantee equivalent in value to the required duties and taxes. The public sector is only required to make a commitment to pay the custom duties in case of failure to export. To obtain the Letter of Guarantee (L/G), the exporter bears several costs: the fee on the L/G (2 percent of the value of the L/G per quarter) and an interest free cash deposit amounting to 15 percent-100 percent of the value of the L/G (depending on the relationship between the exporter and the bank). Under both systems, despite the major improvement in the pace at which applications are processed, exporters still complain about the time to complete the paperwork and prepare the applications in the acceptable form.

Export Regulations. Products are exported through Customs without an export permit, with the exception of the commodities subject to quota (4 items) or quality restrictions (52 items which include citrus fruit, juices, canned vegetables, syrups, some fresh and frozen vegetables, molasses, biscuits and flax-fibers). Such commodities, which represented 5.5 percent and 6.5 percent of total exports in 1988/89 and 1989/90 respectively ($150 million and $205 million), require the approval of the General Authority for Export and Import Control (GAEIC). Quality control on exports has been criticized by many exporters on two grounds. First, quality control over exports, especially agricultural commodities, is sometimes used to favor the public sector. Second, GAEIC does not have the expertise to undertake quality inspection and hence its involvement is unjustifiable.

Tariff Barriers. At present, the highest and lowest tariff rates on imports are 100 percent (except for certain luxury commodities such as cars which are subject to a rate of 160 percent) and 5 percent respectively. This range will be reduced to 80 percent-10 percent as a condition for release of the second tranche of the World Bank SAL. A sales tax, ranging between 5 percent and 30 percent of the value of the imported commodities, inclusive of custom duties, is also levied. The lowest tariff rates apply to basic foodstuffs and raw materials (5 percent-30 percent), while the highest rates apply to finished goods especially luxury commodities such as cars (85 percent-160 percent), cosmetics (85 percent), and certain textile fabrics (85 percent). Certain commodities, such as electrical appliances for domestic use, for which local substitutes are available, also are subject to high tariff rates (100 percent). On average, import duties and taxes added 10 percent ($1.1 billion) to the cost of imports in 1989/90.

Non-Tariff Barriers. According to the import regulations of May 1991, the number of banned commodities has been reduced to 105 items, down from 210 import nomenclature numbers in 1986. As shown in Table 3, overall production coverage of bans decreased from

37.2 percent in 1990 to 22.7 percent in 1991 (a 40 percent reduction), while coverage of other non-tariff barriers (NTBs)- namely, prior government approvals (on 18 items), special conditions (on 15 items)[1] and quality standards (on 69 items)- was reduced from 15.3 percent to 2.9 percent.

Private sector production has been subject to a greater reduction in protection than the public sector. Specifically, private sector coverage decreased by 70 percent (from 36.3 percent to 10.9 percent), while public sector production coverage was reduced by only 40 percent, from 76.4 percent to 47.5 percent. Production coverage of import bans has been greatly reduced for agriculture (from 35.9 percent to 9.8 percent) while the industrial sector (manufacturing & mining) is still subject to a high production coverage of 28.5 percent. Industries such as food processing, paper products, printing and non-metallic products experienced significant reductions. In contrast, textiles, beverages and tobacco, rubber products and chemicals, which fall mainly within the public sector domain, received only small reductions in bans.

1 Of the 15 items, 14 are commodities which may not be imported if they are produced by the "Military Production Factories", which include, for example: diesel engines up to 12.5 horsepower, radiators, agricultural mechanical equipment, and certain types of generators and motors.

Table 3
Production Coverage of Non-Tariff Barriers to Imports
(% of domestic output)

	Public Sector		Private Sector		Overall	
	March 1990	June 1991	March 1990	June 1991	March 1990	June 1991
Bans (NTB1)	49.2%	41.2%	29.3%	10.3%	37.2%	22.7%
-Agr. Sector					35.9%	9.8%
-Manufac & Mining					37.8%	28.5%
Other NTBs	27.2%	6.6%	7.4%	0.5%	15.3%	2.9%
Total NTBs	76.4%	47.5%	36.3%	10.9%	52.5%	25.6%

C. Strategy for Addressing Constraints:

As described above, considerable progress has already been made in liberalizing Egypt's trade regime. This is a major focus of the GOE's economic reform program and is supported by the World Bank SAL and the IMF Stand-By. Nevertheless, significant barriers to trade and impediments to better Egyptian export performance remain. USAID plans to assist the GOE in addressing these constraints through a combination of technical assistance and policy conditionality aimed at complementing the World Bank and IMF programs.

GOE trade sector reforms to date concentrate on the reduction of non-tariff barriers to imports and exports and on the downward leveling of import duties. USAID proposes to focus its trade-related policy dialogue and technical assistance largely on GOE policies or procedures which currently hinder private sector led export growth or constitute a bias in favor of the public sector. Areas of focus will include:

- o improving the temporary admission and duty drawback systems by which Egyptian exporters gain access to duty free inputs;
- o modernization of the Egyptian Customs Administration so as to facilitate importing and exporting and allow the full integration of Customs into the Value Added tax system;
- o identification and elimination of trade procedures and GOE policies which hinder the ability of Egypt's private sector to compete on an equal basis with public sector traders;
- o reducing the production coverage of import bans in a manner that seeks parity between the private and public sectors.
- o eliminating monopoly and monopsony positions of state export and import enterprises.
- o adjusting tariff schedules and import duties to harmonize them with the domestic tax structure, the overall economic reform program and norms of the international economy.

V. Privatization of the Domestic Enterprise Sector

A. Analysis of the Sector

The Domestic Enterprise Sector includes industry, agriculture and commerce, although there is particular emphasis on manufacturing because of the large percentage of capacity that is owned by the Government. Privatization includes, but is by no means limited to, sale of public enterprises to private buyers. The use of the term privatization here should be understood to enterprises to private buyers. The use of the term privatization here should be understood to mean any action that contributes to the transition from central planning and control of economic activity by the government, to a system of private, competitive markets directed by market determined prices, costs and rates of return.

Specific areas of interest, in addition to the obvious area of sale of public enterprises, include: the elimination of government control over pricing decisions; the elimination of barriers to entry by private firms into non-competitive industries; elimination of policies affording protection of favored firms from competition; establishment of a broad array of private market supporting institutions; development of free and open access to information relevant to rational economic decision making; elimination of policies and regulations distorting such private economic decisions as plant location and size, product mix, production technology, suppliers, pricing policy and marketing strategy.

The public sector share of production is very large and Egypt may lead third world countries in public enterprise domination of the economy. Publicly owned firms with 10 or more employees had nearly three times as many employees in 1987 as their private counterparts. Half of these employees are in manufacturing, while the remainder are spread widely among the other sectors. Within manufacturing, publicly-owned companies with 10 or more employees had 565 thousand employees, while the equivalent private sector firms had 193 thousand. Moreover, many joint ventures are majority owned by public agencies, but are counted as private companies.

Growth in the enterprise sector, as elsewhere in the economy, has been discouragingly low in the 1980s. Output and employment in most sectors have not kept up with population, and have even been negative in some cases. For example, the public Textile Holding Company has reduced employment from 300,000 to 250,000 over the last five years. Low levels of investment are one of the symptoms, as well as one of the causes of the problem, with much of the investment being used to modernize facilities rather than increase capacity.

The real reason for the lack of growth is the lack of profitability in the public sector, which usually earns between 2 and 3 percent (in nominal terms) on its investment capital. As banks increasingly use the same criteria in evaluating loan applications, and charge the same interest rates to the public sector as for private companies, a serious (and appropriate) restraint may begin to limit the growth, and even the continued existence, of the less profitable enterprises.

The private sector is constrained by a web of laws and regulations designed to protect the public sector from competition. Thus there are limited domestic sources of growth, and very little from outside. One of the exceptions is tourism where the demand for services has elicited a good response within Egypt. In general, Egypt has not viewed exports as a source of growth to the extent that it has changed the overall policy environment for the enterprise sector.

The public enterprise sector consists of firms under the control of the central government and of Governorates. The latter are smaller but more numerous and most are in the process of being privatized. Approximately 1400 Governorate enterprises were put up for sale in 1991 and 250 pieces of property were sold. There are more than 700 public sector firms at the national level. A total of 383 state-owned enterprises operate under the public companies Law 203. There are at least 250 firms with majority--and in most cases, total--public ownership, that operate under the investment incentives Law 230 and are known as joint venture companies. Another 90 firms are in the process of establishment, but the outcome is uncertain given the policy against new public investment in enterprises. Many of these firms have private ownership-foreign, Egyptian or both - and operate under the same law that governs privately owned firms that take advantage of the investment incentives law. They are able to operate, therefore, more like private companies; privatization also may be easier for these companies to accomplish.

The Law 203 public sector companies employ approximately 1.3 million people with about half of them in the industrial sector (manufacturing). Most of these have been under the control of the Ministry of Industry. Each Law 203 company has been assigned to a holding company and each holding company is assigned to a specific ministry. The organization as of March 1 is contained in Appendix Table 4. Under this system, the Ministries through the holding companies, controlled virtually everything the individual companies did, including the determination of prices, the size of production and product mix, additions to capacity and new investment, (even if from their own resources), the wage structure and wage increases, the hiring of employees (virtually none are ever fired), and the selection (and dismissal) of management.

Law 203, which replaced the former Law 97 and is now being implemented, calls for sweeping changes. The Law is seen as a transitional one that will last for about three years when all public and private companies will operate under the same laws and regulations. Although Law 203 is not a privatization law, it does permit privatization of public sector companies to take place, which is a substantial change. Perhaps the major change is that the Ministries no longer will have any direct role to play in the management of these companies. A new organization has been created, the Public Enterprise Office (PEO), that has a mandate to reorganize the public sector companies into new holding companies (HC), to insure that the HCs and the affiliated companies (ACs) operate according to the guidelines, and to promote and even implement privatization of ACs.

B. Constraints and Barriers to Change

Growth in the enterprise sector has been constrained by the overall regulatory environment affecting the private sector and by the wasteful use of resources in the bloated, inefficient public sector. As conditions have begun to change rapidly, this section concentrates on some factors that may already have been targeted for reform. For ease of presentation, these factors are treated separately for the public and private sector.

The GOE operates a dual system of licensing for any firm that wants to operate in Egypt. A firm first must register under the Company Law 159, by which it chooses its legal form, e.g. joint stock company, limited liability company etc. Then it goes to the appropriate ministry for licensing or applies to the General Authority For Investment (GAFI) for the package of incentives spelled out in Law 230.

This system leaves the Ministries with a great deal of control over any firm. Although the GOE, under the SAL, was supposed to have eliminated the licensing of investment, production and product mix, that has not yet happened. GAFI, through its board, has the authority to license the company and approve the investment without the firm going to the Ministry concerned. The GAFI sends the application to the relevant ministries, however, which also sit on the board that must approve the investment. The GAFI can approve new products, additional activities, expanded investment, etc without going to the board. A company can increase its production by adding shifts without seeking approval from GAFI. It also is free to set prices for its products, subject to the General Price Control Laws, which are in the process of being dismantled under the SAL.

Investment licensing is supposed to have been eliminated except for a negative list that will be phased out by December 1993. The negative list now consists of energy intensive activities, certain assembly industries defined by minimum local content, tobacco products, military industries and all investments in the Sinai except for oil, gas and mineral exploration. There are indications that licensing has not been eliminated and is still an impediment to investment and operations. Requirements for approval for zoning, labor, environmental, health and safety, infrastructure and other considerations appear to be constraining investment.

Restrictions related to labor are another critical area. Companies are not free to hire their employees directly, but must go through the government. Although a draft law has been prepared, it has not yet been passed. The problem of dismissing or laying off employees is well known and still has not been dealt with.

There also are numerous constraints in the financial, fiscal and trade sectors that combine to create an environment, that if not hostile, is not welcoming to the private sector. Some of these problems are dealt with in these other sectors such as the global income tax, limits on the interest rates that bonds can pay, duties on imports, temporary admission/drawback problems, and government monopolies of various imports and exports.

The public sector in Egypt dominates manufacturing and is very substantial in a number of other sectors (see Appendix Table I). Although explicit budget subsidies tend to be relatively low, there are good reasons for privatizing most of them at a rapid rate. Many receive electricity, fuel and certain raw materials such as cotton and cement at below market rates. Not only does this practice raise the cost of these items to the rest of society, or require subsidies, it also permits unfair competition, thus discouraging investment by the private sector. Public sector companies also have been able to get bank loans at low rates of interest; even worse, they have been able to draw on continuing lines of credit to cover operating losses. Because they are public companies, tariffs and non-tariff barriers protect them from the competition of imports to an even greater degree than that which the private sector enjoys.

Private investment in various industries has been prevented in order to protect them from domestic competition as well. For many industrial products, the public sector is the only supplier, which has the insidious effect of making the users of these intermediate products and materials uncompetitive by raising their costs or lowering their quality. Consumers also are hurt by having to pay higher prices or buy low quality goods.

Because the public sector is so large and central to the economy, privatization is necessary as well as improvement in the business environment for the existing private sector firms and for new entrants. There is great scope for improving efficiency in these public sector companies if the new owners are able to reduce the labor force, set their own prices, adjust wages and working conditions and pay a price that reflects the real value of the business rather than a price based on original investment cost and accumulated operating losses.

Although the public sector is being reorganized, the intermediate stage will leave a lot to be desired. Each holding company will have a general assembly that in effect acts as the owners. The government, which is the owner, appointed the general assemblies that are composed of "well-known, experienced and knowledgeable personalities... of integrity with an ability to take good decisions." Some of them are high ranking bureaucrats appointed because of their abilities, not their positions. Their crucial role is agreeing to the board of directors, not selecting them. The Chairman of the General Assembly (GA), who is the minister in charge of the public sector (PEO), proposes the list of nominees. Thus the Government chooses the board of directors of the HC, and chooses the member of the General Assembly, who either can approve or refuse the list. There is no separation of management from ownership in the sense that the GA, which is supposed to represent ownership, cannot choose the management and may have little incentive to review performance.

Another problem is that the new HCs are organized by industry groups so that all the textile firms for example, are in a single HC. This system is likely to produce monopolies, that even if they don't collude against the private sector, are unlikely to operate in a competitive manner that will improve efficiency. Reorganization of the ACs into diversified holding companies that are likely to compete and improve their efficiency is desirable.

C. Strategy for Addressing Constraints

The obvious reforms needed to strengthen the enterprise sector are: 1) improve the economic environment; and 2) privatize public sector firms. Improvement in the policy environment is unlikely to require significant expenditures on the part of the government. Privatization requires mainly the political will to proceed, though project type activities may be necessary for valuing enterprises and arranging their sale. The major cost is likely to be dislocations caused by the failure of some firms as they are faced with competition and/or true economic costs. Firms will have to adjust or fail. Either option is likely to result in redundant labor and possibly the writing off of bad debts. Price increases also may result from some of the reforms, although price reductions also are possible.

The strategy in this sector, as in the others, will be to supplement the policy conditions of the SAL, partly by selecting targets that the GOE has identified in its ERSAP but which are not SAL conditions. Progress on privatization has been made at the Governorate level and there is movement on the sale of hotels.

USAID is well-placed for this sector because its Partnership for Development project is already operating and is the main instrument available to the Government for the reorganization of the public sector and its privatization. The GOE has adopted the strategy that privatization needs to proceed quickly and the way to do it is to privatize the most profitable firms first because these will be the easiest ones to sell. Privatization is important because the public sector is so large that the improvements should be greater than new investment resulting from reform that permits free entry by the private sector. Reform of the operating environment also is vitally important because the privatized firms will be operating in it. Privatization will move more quickly if the potential new owners can see that they will be able to operate without interference.

The SPP will emphasize policy reform and privatization but will not specifically address the possible dislocations except by requiring that the GOE's privatization plan include considerations of labor redundancy. The World Bank has funded the Social Fund for Development (SFD) that is intended to alleviate the sufferings brought about by restructuring. A number of other bilateral donors have pledged substantial amounts to the SFD. The dollar disbursements resulting from policy reform under the SPP will generate local currency that the GOE can use to increase its expenditures on SFD activities.

IV. CONCLUSION

As the foregoing sections demonstrate, the economic reform program that is required to reach Egypts quantitative and qualitative growth goals is comprehensive and monumental. It implies short run costs that could be severe if the accompanying Social Fund does not begin to display agility and efficiency in identifying those who stand to bear the brunt of the wrenching adjustments, and in establishing mechanisms to protect those who cannot defend themselves.

Comprehensive structural adjustment implies closure of some factories, sharp cutbacks in some areas of production, large reductions in the size of the workforces in some industries, and open and public recognition of the bankruptcy of many establishments. It will involve radical changes in the crops grown by many farmers, and the abandonment of farming altogether by others. Financial insolvency will afflict not only the commodity sectors but some of the banks that have financed them as well. In the political/bureaucratic realm, empires will shrink, perquisites will evaporate and power will dwindle. In the private sector, many of those who have prospered by implementing the government's economic schemes, without any need for efficiency or for developing the skills and expertise to compete in the international economy, will face a sink-or-swim reality in unfamiliar waters.

economic reform, is not lost on them. Together, they form a formidable resistance movement. Thus the mere act of openly commiting itself to such a program was frought with political risk for the Mubarak Government. This program promises short-term (maybe) pain to identifiable segments of the community, in exchange for long-term gains to be enjoyed by who knows who? Yet the GOE has not backed away from its identification with the program. Thus despite the often repeated observation that the GOE has timidly taken the necessary steps toward stabilization, has shown little progress toward shedding its economic enterprises, and can't seem to get the social fund off the ground should not be allowed to lead to despair. Strong donor support and patience, blended with friendly nudges as needed are indispensable to a successful--if slow--effort. This is the persistent theme of U.S. support for economic reform.

The specific indicators and targets which are intended to measure progress toward outcomes will be contained in an auxiliary document.