Monitoring Progress Under SPR and Assisting the GOE in Achieving the SPR Policy Measure to Make Investment Incentives More Cost Effective.

Final Report

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INTRODUCTION

The purpose of this study is to assess and compare the cost effectiveness of Egypt’s investment incentives program under Law 8 with that of earlier legislation. The study was conducted by Siegfried Marks, Senior Macro-Economist, and Pierre Gianni, Senior Attorney and Tax Specialist. They were assisted by Taha M. Khaled, Managing Partner of Zarrouk, Khaled & Co., a respected Egyptian Public Accounting firm, and by Soheir El Sherif and Mervat Doss, senior economists at the TAPR office in Cairo. The project started October 20, 1998 and was completed December 18, 1998 in Egypt.

The views expressed in this study are solely those of the authors and are not intended as statements of policy or opinion of the GOE, USAID, or Chemonics International Inc.

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Methodology

The authors reviewed Law 8 of Investment Guarantees and Incentives and its Executive Regulations as well as all other current and recent past laws relating directly or indirectly to investment incentives. They also reviewed a number of other publications dealing with Egypt's investment incentives, impediments to investments, the Egyptian economy, shortcomings of Egyptian economic statistics, other countries' investment incentive laws and regulations, and statistical information about the private sector response to Egypt's investment incentives. The authors used information from the USAID library, the office of the General Authority for Investment, the International Monetary Fund, the International Finance Corporation of the World Bank, and other sources.

Extensive interviews and telephone discussions were held with contacts from the GOE, international financial institutions, think tanks, private sector organizations, and private companies. Written requests for specific data and information were sent to public entities and prompt responses were received.

The legal part of the study describes concisely the investment incentives offered by the GOE currently under Laws 8 and 159 and under previous legislation. The economic part of the study focuses on an assessment and comparison of the cost effectiveness of Egypt's investment incentives program under Law 8 and previous legislation.

Some useful data was obtained for measuring and comparing cost effectiveness of investment incentives, such as the number of companies approved for investment incentives, the planned investments and jobs to be created by the tax-exempt firms, free zone investments and output stimulated by the incentives, and foreign investment attracted by incentives. The available data was inadequate, however, for a complete assessment. There is no data available to measure the multiplier effects of the investments stimulated by incentives, such as the additional sales, production, services, jobs, income, and tax revenue generated among suppliers, contractors, infrastructure and service providers to the tax-exempt companies.

The problem for the economic analysis was further compounded by the relatively newness of Law 8. It was implemented only on May 11, 1997 -- too soon for most companies authorized to receive incentives under this Law to have completed their investment, to have started production, and to have generated tax-free profits.

EGYPT: COMPARISON OF COST EFFECTIVENESS OF INVESTMENT INCENTIVES

1.0 Executive Summary

The purpose of this study is to assess and compare the cost effectiveness of Egypt's investment incentives program under Law 8 with that of earlier legislation. As part of this effort,

- The current Law 8 was compared to previous legislation to clarify the applicability and eligibility of the legislation and to outline the changes that have taken place;
- Related legislation affecting investment incentives was also examined;
- Streamlining of procedures for establishing businesses was assessed;
- The distribution of new businesses among the main sectors receiving incentives under Law 8 compared to earlier legislation was analyzed;
- Qualitative factors were identified in comparing the cost effectiveness of tax holidays under Law 8 to previous legislation;
- To the extent data was available, quantitative analyses of the cost effectiveness were undertaken, measuring and comparing the impact of investment incentives under Law 8 and previous legislation on the growth of the number of new companies, amount of investment, employment, and exports;
- A statistical analysis was prepared about investment incentives stimulating the development of the free zones under Law 8; and
- The impact of the fiscal incentives program on tax revenues was discussed, but data was unavailable for a quantitative assessment and comparison.

Cost effectiveness assesses the costs related to the benefits of a project or a program. The direct cost is mostly the tax revenue lost to the government by granting fiscal incentives. Indirect costs relate to such factors as the distortion of competition, interference with the operation of market forces, capital diversion from more to less productive uses, and discrimination against those companies that are not eligible for incentives.

The direct benefits in an assessment of cost effectiveness are the production, sales, income, exports, and jobs generated from the new investments that would not have been made without the investment incentives. The indirect benefits relate to the array of ancillary activity stimulated by such a new investment for domestic producers, suppliers, contractors, bankers, distributors, and other service suppliers who in turn generate additional production, sales, income, jobs, and tax revenue. The indirect benefits can at times be larger than the direct benefits or than the costs associated with investment incentives, particularly in an economy with large underutilized capacity or unused resources and factors of production.

Due to the unavailability of reliable or complete data, tax analysts often concentrate only on the cost side of the equation and thereby produce a least cost analysis instead of a cost effectiveness assessment.

A critical problem for cost effectiveness analysis is the problem of determining how much of the investment receiving fiscal incentives would have been made regardless of the incentives. For these cases, tax incentives are not cost effective, because the government gives up tax revenue that does not have to be given up. Another similar problem is to determine the amount of investment and benefits for the economy that would have been lost if the government had not offered the investment incentives. These two issues, however, are not very relevant for this study, which deals with a comparison of the cost effectiveness of essentially identical fiscal incentives under Law 8 versus previous legislation. Thus it can be assumed that, under both sets of incentive laws, the same companies would have been swayed by factors other than tax holidays in their investment decisions.

1.1 Summary Conclusion of Cost Effectiveness Assessment

On balance, the investment incentive program under Law 8 was found to be more cost effective than that under previous legislation.

The ways in which the Law 8 program is clearly more cost effective include:

- Substantially more companies approved for incentives under Law 8 than during the comparable period under previous legislation;
- More investment planned in most eligible activities with Law 8 incentives than with previous legislation during a comparable period;
- The largest job creation in industry during fiscal year 1997/98 when Law 8 incentives were operating for all new investments in all industrial sectors;
- Faster growth of non-traditional and unclassified exports in fiscal 1997/98 than during the previous fiscal year, while total exports decreased in fiscal 1997/98, but grew in 1996/97;
- Mostly automatic, streamlined, and speeded up approvals for investment incentives under Law 8 compared to committees of government officials spending time and government expense pondering each incentive application under previous legislation;
- Investor certainty of eligibility for incentives under Law 8 replaced earlier uncertainty, arbitrariness, and discretionary power by the approval authorities;
- Consolidation of all investment incentives under Laws 8 and 159 replaced a number of laws governing specific activities singled out for investment incentives under different eligibility criteria; and
- No extensions of tax holidays under Law 8 for the government to start collecting taxes earlier than under previous legislation when extensions were often granted.

The ways in which the investment incentive program under Law 8 is less cost effective include:

- A diminishing share of total shipments from the free zones is exported, and the free zones are becoming increasingly used as simple import operations by predominantly Egyptian companies enjoying permanent tax holidays; and
- A reduced share of Arab and other foreign investment was attracted by investment incentives in 1997 compared to 1996, and only a small relative increase took place during the first ten months of 1998.

An assessment of the above concludes that the increases in cost effectiveness are greater than the decreases.

- Lack of data precluded a comparison of other aspects of cost effectiveness between Law 8 and earlier legislation, such as tax revenue lost due to the tax holidays and tax revenue gained as a result of the multiplier effects of investments stimulated by investment incentives. A quantitative assessment would require data about the profits generated and taxes paid by the tax exempt investments and the taxable income generated by the array of ancillary activities stimulated by the tax exempt investments. It would be necessary to separate the taxes paid on profits from these activities from total taxes by the companies providing inputs and services to the tax exempt companies. Added to the tax revenue calculation would be the personal income taxes paid by the work force of the tax exempt companies as well as by the additional workers employed by companies benefiting from the tax exempt investments. An available input-output matrix for the Egyptian economy tabulates the input coefficients for Egypt's industry sectors only for fiscal 1996/97. It does not include data on employment or profitability from which to derive the tax revenue impact.
- It should be noted that the main source of the data used in this study is from the General Authority for Investment and Free Zones (GAFI), which publishes only data of planned rather than actual investments and employment generated by the investment incentive program. GAFI makes no information available on exports or foregone government revenue from tax exempt companies.

Among specific findings have been the following:

- The number of companies eligible for tax holidays under Law 8 versus previous legislation accelerated from 661 to 2,221 during comparable periods of time under previous legislation versus Law 8. This is a clear indication that more companies availed themselves of investment incentives under the current law.

- Planned capital issues by companies eligible for a tax holiday expanded steadily and substantially. Increases accelerated from LE 4.3 billion in 1996, the last full year under previous legislation, to LE 15.4 billion during the first ten months of 1998 under Law 8. Total planned investments, including financing, expanded from LE 21 billion during 1996 through May 1997 to LE 46 billion from June 1997 to September 1998, the period during which Law 8 has been operational.

- The average size of investments granted tax holidays declined from LE 20 million during 1994-96 to LE 12 million in 1997-98.

- Tax holidays have benefited mainly Egyptian companies. Measured in terms of issued capital, only 7% was Arab and 12% non-Arab foreign during the first ten months of 1998.

- The fastest job creation in the Egyptian economy in absolute and in relative terms occurred in industry and in fiscal 1997/98 when Law 8 started operating. Job creation in industry expanded 7% in fiscal 1997/78 compared to 4% in 1995/96 and 3.7% in 1996/97. Actual and planned job creation in all sectors receiving incentives was 151,000 during the first ten months of 1998 compared to 82,000 during the corresponding period in 1997.

- Statistics are not available to separate exports generated by tax exempt companies from exports by tax paying companies. Non-traditional and unclassified exports expanded 21% in fiscal 1996/97, but 24% in fiscal 1997/98 when total exports declined nearly 5%. It can be assumed that tax exempt companies played a major role in the expansion of non-traditional and unclassified exports.

- In the free zones, where companies enjoy a tax holiday permanently,
  - Egyptian companies dominate with 85% of total capital invested,
  - 90% of imports into the free zone come from abroad, mostly from Asia,
  - 77% of the products shipped out of the free zone end up in Egypt.

  In other words, mostly Egyptian companies have been enjoying a permanent tax holiday on profits from conducting import operations using the free zones. Other countries offer tax incentives in free zones for re-exporting, not importing, using low cost local labor. The GOE has now recognized this flaw in Law 8 and issued Decree 619 on December 10, 1998 prohibiting the storing of finished goods in the free zones for transshipment into the domestic market.

In developing a comparison of the cost effectiveness of the investment incentive program under Law 8 versus earlier legislation, informed sources made relevant observations applicable equally to both the current and previous incentive legislation.

- Tax holidays are important for some companies to offset the inflated costs of doing business in Egypt, such as high import duties, time-consuming, costly procedures of moving cargo through ports and customs, obtaining duty drawbacks, and suffering additional costs due to inflated reference prices imposed on imports when calculating import duty payments. Reducing these and similar inefficiencies would have the effect of lowering the cost effectiveness of tax holidays. Many Latin American countries were thus able to replace tax holidays altogether with a set of investment guarantees.

- Consumer goods companies operate in a highly competitive market with narrow margins. They, reportedly, have found investment incentives under Law 8 and earlier legislation crucial for the viable start-up of new investments. It is not clear, however, whether import protection or tax holidays were the more important factor in the decision to invest.

- Technology transfers were one important criterion for approving fiscal incentives for new investments under the previous Law 230 approval process. Under Law 8, technology transfers are left free to market forces.

- A five-year tax holiday is being offered, under Law 8 and also under earlier legislation, to all new investments in all industries, large and small, irrespective of the potential size of its benefits to the economy. This is not a cost effective approach.

- Many new investments, particularly in the industrial sector, would have been made regardless of the tax incentives. In the case of these investments, the government suffers a net tax loss equal to the taxes not collected during the tax holiday, without any offsetting benefits.

- It is arguable whether companies are attracted to new urban centers and desert areas by tax holidays or by the existence of efficient, new infrastructure, rapid, non-congested transportation, subsidized utilities, low rents, and other non-tax benefits. The cost effectiveness of tax holidays is low for companies where these non-tax benefits are decisive for investing.

- In reviewing the investment incentive program under both Law 8 and previous legislation, it can be concluded, that
    - the Government of Egypt (GOE) is too generous by offering fiscal incentives to all new investments in all industries and thereby giving away tax revenue to many companies that would have made the investment regardless of incentives;
    - the incentives should be targeted more narrowly to sectors closely related to priority national economic goals; and
    - other forms of fiscal incentives, such as investment tax credits and accelerated depreciation could be considered as better alternatives to tax holidays, because they reward investments rather than profits and they yield some tax revenue for the GOE already in the first profitable year of the investment.

  These options would prove more cost effective than the current investment incentive program, which is based on tax holidays offered indiscriminately to a very broad sector of the Egyptian economy.

- A more aggressive, on-going foreign investment promotion campaign could be developed, patterned after successful examples in Latin America that resulted in up to $60 billion in direct foreign investment per year. The strategies should be pro-active using diverse means of communication in foreign investors' own countries to acquaint them convincingly to the attractive investment incentive program, new investment opportunities, progress with government economic reforms, removal of impediments to private investment, financial and political stability and security.

- Consideration should be given to a comprehensive review of the government's free zone policy, legislation, and administration after detailed analysis of the evolution of the Panama Free Zone operation into the world's largest or second largest free zone. No country in the world has a similar geographical location to Egypt like Panama. The existence of a canal in both countries places them in an enviable locational and transportation advantage unmatched by other countries. Panama has taken full advantage of its situation by offering international private companies attractive opportunities to centralize manufacturing, assembly, mixing, warehousing, and distribution in its free zone adjacent to the canal for transshipment to the Central and South American markets. Panama has pursued an international trade policy that combines the existence of the Canal with the Panama Free Zone and two adjacent major modern transshipment facilities built and operated by experienced private international shipping and stevedoring companies. Egypt should investigate whether it can follow Panama's successful example.

1.2 Legislation.

Egypt's legislation affecting private investment is diverse and complex. The statutes are code-based, some fundamental texts are outdated, and numerous laws overlap each other. Notwithstanding recent reforms, it is not easy in this complicated context to determine what law governs what.

Three main texts are the basis of Egypt's investment incentive legislation:

- The **Companies Law**, Law 159 of 1981

- The **Income Tax Code**, Law 157 of 1981, and

- The **Investment Law**, Law 8 of 1997

Specific texts also govern targeted investment activities, essentially:

- The **Hotels and Tourist Constructions Law**, Law 1 of 1973

- The **New Urban Communities Law**, Law 59 of 1979, and

- The **Desert Land Law**, Law 143 of 1981

While Law 8 did realize some unification of the above texts, particularly with regard to tax benefit provisions, these targeted laws still exist and must be considered in a comprehensive analysis of Egypt's investment incentive legislation.

In addition, the legal and regulatory framework in general also has an effect on a prospective investor's decision. Thus, commercial law, labor law, social security law, customs and tax law, capital markets law, intellectual property law, and the judicial system must be considered in a study of investment incentive legislation.

All these laws are discussed to various degrees in this study. The fundamental investment incentive text is, however, **Law 8.** Law 8 is Egypt's fourth investment incentive law and has replaced the former investment law, Law 230 of 1989. A major characteristic of Law 8 is that **no minimum investment nor approval process** is required. Still, Law 8, is a **targeted investment law.** For sixteen separate categories of activities, ranging from reclamation of desert land to industry and mining, air transportation, and the tourism industry, among others, Law 8 provides two main types of incentives:

- **Investment guarantees.** These guarantees cover in particular nationalization, pricing interference, land ownerships rights, importation rights, and also include exemptions from certain corporate law and labor requirements.

- **Tax incentives.** Law 8 provides several tax benefits, mainly (1) an income tax exemption ranging from five to twenty years depending on the location of the investment, (2) a stamp tax exemption on contracts and other legal documents, (3) an exemption from the tax on interest-type income, and (4) a reduced rate of five percent on all imports needed for the investment.

In addition, Law 8 provides specific benefits for business entities allowed to operate within certain geographically delimited areas, known as "**Free Zones.**" In principle, the benefits of Free Zone status are restricted to certain industry-type or export-oriented activities. A primary characteristic of the free zones is that they are **not subject to customs taxes or procedures.** In addition, profits realized are **not subject to Egypt's tax laws**, except for a one percent duty on the goods stored or processed within the zones.

A special government agency, the General Authority for Investment (GAFI) is in charge of supervising all aspects of Law 8 and free zone investments.

Recent changes in Egypt's legal framework affecting private investment are also analyzed in this study. Of particular significance is **Law 3 of 1998**, which considerably streamlined the incorporation process. Other laws, in particular in the capital markets area and in the taxation field, were also enacted in recent years to facilitate private investment and business operations.

The main differences between Law 8 and Law 230 are also analyzed in this study.

Finally, in an assessment of all the recent changes that have been brought to the investment incentive legislation in recent years by the Government of Egypt (GOE), the following points are emphasized:

- **Significant progress** has been made by the GOE in recent years in the legislation area to facilitate the development of private investment in Egypt. Improvements are still needed, particularly in terms of unifying the legislation. Steps are already being taken by the GOE, as several major comprehensive projects are under way.

- Regarding the cost-effectiveness of tax incentives, other factors usually outweigh tax considerations. While tax incentives have a cost, **facilitating laws, updated legislation, and**

flexible administrative procedures do not result in foregone revenues. Recent changes of attitude by various countries regarding **tax sparing** should also be taken into consideration by the GOE in its efforts to **rationalize** tax incentives.

2.0 Existing Legislation[1].

2.1 Basic Legal Structure.

Egypt's economic law reflects the rich history of the country. The law has its foundations in jurisprudential influences carried over from the Ottoman Empire (ended in 1914), the British Protectorate (1914-1922), the Monarchy (1922-1953), and the period of socialist economy (1953-1974). In addition, in recent years, new legislation has been enacted to further the development of a modern private sector and a market-driven economy.

Egypt's legislation affecting private investment is thus diverse and complex. The main characteristics of this legislation are:

- **Code-based statutes.** The primary source of the law is the code rather than cases. An important consequence is that legal provisions are generally very detailed and not enabling.

- **Some statutes are outdated.** The Commercial Code dates back to 1883. The Civil Code, an essential component of economic law as it regulates contracts and formation of companies, was enacted in 1948. Although both codes were subsequently amended, they do not fully reflect modern trends and thinking.

- **Intermingling of the laws.** One single legal issue is often dealt with by several laws. This adds to the confusion already resulting from the variety and diversity of the laws.

Investment incentives legislation suffers from the same flaws outlined above. Notwithstanding recent reforms, several statutes still govern investment incentives. In this complicated context, it is not easy to determine what law governs what.

2.2 Main Investment Incentive Legislation.

2.21 Law 159.

Prior studies of Egypt' s legal framework have identified Law 159 of 1981 as one of the main laws directly affecting private investment.[2] Indeed, incorporation is generally the first step taken by a potential investor in any country. Law 159, completed by the Civil Code and the Commercial Code, is the main Egyptian corporate law. It has replaced the former General Companies Law, Law 26 of 1954. It is based on French corporate law and includes the same types of business entities and similar provisions for their organization.

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[1] This study does not cover incentive legislation for oil and gas exploration, as these activities are subject to specific arrangements between the Government of Egypt and foreign oil companies.

[2] See, in particular, "Egypt, a Comparative Study of Foreign Direct Investment Climates", prepared for USAID-Cairo, August 1997, James Kenworthy and Siegfried Marks - Nathan Associates.

Law 159 is composed of two main texts: the law itself and its Executive Regulations (Law 159 Regulations). It has been amended on several occasions. The main provisions of the law affecting private investment are discussed below.

- **Investment incentives.** Law 159 does not directly provide investment incentives. The law only addresses investment incentive provisions by reference to other laws, *i.e.*,

  (1) Grandfather rule for Law 43 benefits. Article 183 of Law 159 states that investments made under Law 43 of 1974 will continue to enjoy the benefits granted under that law. Law 43 of 1974 is Egypt's former investment law "for Arab and foreign capital investment." It was superseded by Law 230 of 1989. Law 230 itself has been repealed almost in its entirety[3] and is now replaced by Law 8 of 1997 on Investment Guarantees and Incentives.

  (2) Minimum Egyptian capital contribution. Article 11 of Law 159 Regulations states that at least 49 percent of the shares of a joint stock company formed with public offering of shares must be offered for subscription to Egyptian nationals for a one-month period. An exception to this general rule is provided by the same article for companies formed "under the law of Arab and foreign capital investment," *i.e.*, Law 43 of 1974.

- **Types of Business Entities.** Four main types of business entities are allowed under Law 159:

  (1) the "**Partnership**," similar in its conception to the U.S. "General Partnership," in that partners have unlimited liability and the transfer of shares is restricted,

  (2) the "**Commandite**" and the "**Commandite with Shares**," close in their nature to the U.S. "Limited Partnership," with one or more partners unlimitedly liable for the debts of the business and other partners with liability limited to their capital contribution,

  (3) the "**Limited Liability Company**," which cannot be formed or increase its capital through public offerings and is not allowed to issue negotiable shares,

  (4) the "**Joint Stock Company**," equivalent to the U.S. "Corporation," with limited liability of shareholders, and which can issue publicly traded stock.

- **Incorporation.** Several steps must be taken for the formation of an Egyptian corporation. First, the articles of incorporation and by-laws[4] must be drafted in a rigid format approved by the government. Then, a portion of the funds representing the initial capital contribution must be deposited in an accredited bank. Notarization of the articles of incorporation by a government Notarization Office is required . The formation of the corporation must then be approved by the government agency in charge of supervising companies formed under Law

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[3] Except for Article 20, paragraph 3 of Law 230 which states that employees are entitled to a ten-percent share of distributed profits. Law 8, Article 4.

[4] Typically unified in a single document in Civil Law countries.

159 (the Companies Authority). The articles of incorporation and other documentation must then be filed with the Registry of Commerce. Finally, a publication of a statutory notice in an official gazette is required before the corporation can receive its formal notification of existence as a legal entity. Law 159, Articles 15 through 30; Law 159 Regulations, Articles 10 through 58.

- **Statutory capital requirements.** The law sets detailed requirements regarding the minimum initial capital contribution. Generally, for joint stock corporations, the minimum initial capital must not be less than 250,000 Egyptian Pounds[5] (LE). This minimum is raised to LE 500,000 for corporations offering their shares to public subscription and LE five million for holding companies and companies dealing in securities. Shares issued for cash do not have to be paid in full at the time of their issuance. The law, however, requires that the minimum paid be no less than one-fourth of the amount, with the balance paid over five years. Also, special rules apply to shares not completely paid-up regarding distribution of dividends and sale or exchanges. Law 159 Regulations, Article 6. For Limited Liability Companies, the initial capital must not be less than LE 50,000 and must be paid in full at the time of incorporation. Law 159 Regulations, Article 67.

- **Foreign investors.** As noted above, except for companies formed under the law of Arab and foreign investment of 1974, the law requires that a minimum of 49 percent of the shares of a joint stock company formed by public subscription be offered for subscription to Egyptian nationals for a one-month period. Law 159 Regulations, Article 11.

- **Employees' share of profits.** Employees are entitled to a minimum of ten percent of the profits distributed by a joint stock company. Law 159, Article 41. This provision likely reflects Article 26 of Egypt's Constitution, which provides that all workers should have a share in the management and profits of projects.

- **Hiring of Egyptian nationals.** Article 174 of Law 159 requires that a minimum of 90 percent of all employees of Egyptian companies be of Egyptian nationality. Their total earnings must not be less than 80 percent of the total amount of salaries paid. Article 175 reduces the above percentages respectively to 75 percent and 70 percent in the case of "shareholders' companies", *i.e.*, principally joint stock corporations.

2.22 The Income Tax Code.

Although this has not always been made clear in prior studies, in addition to the tax incentives provided by investment laws, the Egyptian Income Tax Code contains specific tax incentive provisions for investment and reinvestment. Those provisions are very similar to the provisions of tax codes currently in effect in several countries in Francophone Africa.

Law 157 of 1981, as amended, is Egypt's Income Tax Code (the Code). This code is based on the schedular system of taxation, *i.e.*, a system where different sources of income are

[5] U.S. $1 equals app. LE 3.40

taxed according to separate rates and rules[6]. The corporate tax[7] is assessed in a schedule known as "Revenues of Industrial and Commercial Activities." This schedule is used for corporations as well as for sole proprietorships. For corporations, the current general tax rate is 42 percent[8]. This rate is reduced to 34 percent[9] for "industrial" companies and profits derived from export operations. Taxable income is determined based on generally accepted accounting principles and is adjusted according to the Code's provisions regarding allowances for depreciation, bad debts, ordinary and necessary expenses of business, and special deductions.
The Code's main provisions granting tax benefits for investment are as follows:

- **Income Tax deferral for reinvestment.** Article 117 of the Code suppresses the requirement that income be recognized when the proceeds from the sale of a capital asset are reinvested in a similar type of asset. This provision in fact works mostly like a tax deferral provision rather than a tax exempt provision, as the amount of the gain realized on the sale reduces the basis available for depreciation of the new asset acquired. There is thus a recapture of the tax savings through a lesser basis for depreciation. Nevertheless, it is a significant tax incentive provision for reinvestment.

- **Tax deduction for investment in industrial assets.** Under Article 27 (3) of the Code, a deduction from the basis of the corporate tax is allowed for the acquisition of assets used in "production" activities. The amount of this deduction is equal to 25 percent of the cost of the assets. Even though depreciation allowances must be computed on the reduced basis of the assets, the deduction can result in significant tax savings. The term "production" is vague but this provision should in principle benefit only industrial-type activities and not services.

- **Five-year income tax exemption for new factories.** Article 120. 8. provides a five-year tax exemption from the corporate tax for new factories employing at least 50 persons. The exemption starts the first year following the beginning of production activities. A separate accounting of the operations of the new factory is required. No other conditions are set by the Code.

- **Special exemption for paid-in capital.** Under Article 120.1 of the Code, companies that are listed on the Egyptian Stock Exchange have the benefit of a special income tax exemption equal to the product of their paid-in capital times an interest rate set by the Central Bank. The amount of the exemption is thus equal to the theoretical return that investors could have earned by investing in bank deposits. Hence, publicly listed companies are subject to the corporate tax only on the amount of profits beyond the theoretical return on paid-in capital.

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[6] Although a step towards a unified system of taxation was made in 1993 by Law 187 (The Unified Tax Law). This law unified some of the schedules used for personal income tax purposes.
[7] Labeled "Tax on Profits of Stock Companies" since the Unified Tax reform of 1993. Law 187, Article 2.
[8] Inclusive of the two percent Development Tax that applies to profits above LE 18,000 (U.S. $ 5,200) annually.
[9] Inclusive of the two percent Development Tax.

- **Other.** In addition, the Code provides tax incentives for less significant targeted investments. Among those tax preferences are the following: a ten-year income tax exemption for companies operating in the field of "land reclamation and cultivation" (Code, article 120. 6); an exemption for "bee breeding" (Code, Article 120. 5.); and an exemption for "poultry, cattle companies" and fisheries (Code, Article 120. 7.)

2.23 The Main Investment Incentive Law: Law 8.

Law 8 of 1997 on Investment Guarantees and Incentives replaced Egypt's former Investment Law, Law 230 of 1989. Law 230 itself had replaced the former investment law, Law 43 of 1974 on "Arab and foreign funds".

Law 8 was enacted after a lengthy process. Several drafts were circulated before the final decision was made. Law 8 is composed of two main texts: the law itself and its Executive Regulations (Law 8 Regulations). The essential features of Law 8 are as follows:

- **Qualifying activities.**[10] Sixteen different types of activities qualify for the benefit of the law:[11]

  (1) Reclamation and cultivation of barren and desert lands

  (2) Animal, poultry and fish production

  (3) Industry and mining

  (4) Hotels, motels, boarding houses, tourists resorts, and tourist transportation

  (5) Transportation of goods in cooling vans, cold storage installations for agricultural products, industrial products, food, and containers and silos for grain

  (6) Air transport and directly related services

  (7) Sea transportation of goods and passengers outside territorial waters

  (8) Oil exploration services and transport and delivery of gas

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[10] Egyptian laws are published in the Arabic language. English translations are poor and confusing. In order to avoid any false interpretation of the law, the listing discussed below has been kept as close as possible to the available English translation.

[11] According to information we obtained from GAFI at the time of finalization of this report, a new field had just been added to the current sixteen categories. This new field would cover all investments made in "special economic zones" as designated by a Presidential Decree. Apparently, these zones would cover much larger areas than the existing "New Urban Communities" zones or "Desert Land" zones. The whole Sinai peninsula was indicated to us as a possible example of such "special economic zones." No further information on this recent change is available at this time.

(9) Housing projects other than housing for administrative purposes

(10) Infrastructure projects including potable water, sanitary drainage, electricity, roads and communications

(11) Hospitals and certain medical centers

(12) Finance leases

(13) Guarantee of subscription in securities

(14) Risk capital

(15) Production of computer programs and systems

(16) Projects financed by the Social Fund for Development

The law also states that other qualifying activities may be added by decree. Law 8 Regulations further detail and clarify the activities listed above.

- **Investment guarantees.** Law 8 provides various guarantees for investment. Those guarantees cover nationalization (Article 8), administrative seizure or sequestration (Article 9), pricing interference and determination of profits (Article 10), rescission of licenses (Article 11), land ownership's rights (Article 12), and the right to import directly or through intermediaries raw material and equipment (Article 13). The law also provides various exemptions from certain corporate law and labor law requirements (Articles 14 and 15).

- **Tax incentives.** Several types of investment tax incentives are set forth in the law.[12]

(1) Income Tax Exemption for a period of five years, starting from the first year following the beginning of the production. This exemption benefits corporations as well as individuals. The exemption is extended to ten years for investments made in specific remote areas (new urban communities or new industrial zones). A 20 year exemption is granted to investments made outside the Old Nile Valley. Law 8, Articles 16 through 19.

(2) Exemption from the Stamp Tax and notarization/registration fees for three years starting from the date of the registration with the Registry of Commerce. Law 8, Article 20. The Stamp Tax is an antiquated form of taxation characterized by payment of a specific tax on a wide range of documents, *e.g.*, contracts, minutes of companies meetings,

[12] According to a recent brochure published by the Ministry of Economy, expatriates' salaries are exempt from Egypt's income tax if their stay in Egypt is for less than one year. We did not find any citation for this exemption in the law. Further, renowned tax practitioners approached about this subject stressed that there is no such general exemption under current law.

commercial papers, court orders. The tax is generally nominal but is a nuisance in business transactions[13].

(3) Special income tax exemption. Companies that are listed on the Egyptian Stock Exchange have the benefit of a special income tax exemption for an amount equal to the product of their paid-in capital times an interest rate set by the Central Bank. Law 8, Article 21. This exemption is identical to the exemption provided by the Tax Code under its Article 120.1.

(4) Exemption from the tax on interest income. Income from registered bonds and other finance instruments issued by publicly listed companies is exempt from the Tax on Movable Capital. Law 8, Article 22. The Tax on Movable Capital is a schedular tax that applies at the rate of 32 percent on interest-type income.

(5) Reorganizations. Reorganizations resulting from mergers, split-offs, or changes in legal status of companies operating under the law are exempt from tax. Law 8, Article 24. Also, a reorganization will not end prematurely the tax incentive benefits. Such a reorganization will not, however, extend the period for which the tax benefits were originally granted. Law 8, Article 25.

(6) Capital gains. An income tax exemption is provided on capital gains realized on the transfer of assets to a new legal entity as a capital contribution. Law 8, Article 26.

(7) Customs Taxes. Customs taxes apply at a flat rate of five percent for all equipment and machinery imported for investment projects made under Law 8. Law 8, Article 23. Customs taxes normally apply at various rates ranging from five percent to 70 percent.

- **Land allotment.** State-owned land may be allotted free of charge or for a nominal rent for investments made in designated areas. Law 8, Article 28; Law 8 Regulations, Articles 22 through 27.

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[13] Notwithstanding its nominal amount, because of its wide range, the stamp tax is the third source of Egypt's indirect tax revenues, after customs duties and sale taxes.

- **Exemptions from labor law and social security law[14] requirements.** Law 8 companies are exempt from various certain labor law requirements. In particular, Law 8 companies can freely hire Egyptian staff and are also exempt from the compulsory provisions set by Law 159 regarding employees' participation in companies' management. Law 8, Articles 14 and 15[15]. Law 8 companies, however, are still subject to the general requirement that ten percent of the distributed profits be allocated to employees. Law 8 did not repeal this compulsory provision of Law 230. Law 8, Promulgatory Decree, Article 4.

- **Free Zones.** Special incentives are provided for investments made in "Free Zones." Free Zones are designated areas that are administered by a special representative body of the government according to specific sets of rules and administrative regulations. Apparently[16], the main requirement set for admission to Free Zone Status is that at least 50 percent of the production must be exported. Law 8 Regulations, Article 29. A primary characteristic of the Free Zones is that they are not subject to customs taxes or customs procedures. With some exceptions, this exemption applies to raw materials imported to be processed within the Free Zones, as well as to equipment and machinery used for this production. Law 8, Article 32. However, goods produced within the Free Zones and sold on the "local market", *i.e.,* in Egypt, are subject to customs taxation. Law 8, Article 33.

  Another important element of the Free Zone status is that the profits realized are not subject to Egypt's tax laws, except for a one percent tax on the value of the goods stored or processed within the zone or, alternatively, a one percent tax on gross income if no input components are used. Law 8, Article 35. No income tax is apparently levied, however, on profits made on the sale of goods on the local market. In addition, various exemptions from certain corporate law and labor law requirements are granted to Free Zone investments.

- **Other.** Law 8 includes transitory provisions for investments made under previous tax incentives regimes. The law states that the benefits and privileges of previous exemptions

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[14] According to a recent brochure published by the Ministry of Economy, Law 8 companies are not subject to the general social security scheme for Egyptian employees. According to the brochure, Law 8 companies are free to organize their own social security scheme, provided that such scheme offer equal or greater benefits than the general scheme. Social security law specialists that we approached on this subject indicated that the brochure's statement is not correct. Those specialists emphasized that under current law, the general social security scheme for retirement is compulsory for all Egyptian employees. A specific retirement plan could be organized for Law 8 employees in addition to, not in substitution of the general regime. Substitution plans are allowed only for medical coverage, and this possibility is open to all private companies, not solely Law 8 companies.

[15] A specific procedure is nevertheless organized for the representation of employees in the management of Law 8 companies. See Law 8 Regulations, Article 14 through 18.

[16] Neither Law 8 nor its regulations set specific criteria for admission to Free Zone status. The only reference we found to the export requirement is an indirect reference in Law 8 Regulations, Article 29, for companies converting their operations from "inside Egypt" to a "private free zone." As is further discussed below in this report, the decision to grant a license for Free Zone status apparently rests with GAFI authorities, based on their own internal rules for admission.

expire at the normal date set for their termination. Law 8, Article 2. No conditions of minimum investment or nationality of the investors nor requirements regarding the choice of a business entity are set under Law 8. Further, the benefits of the new law are apparently granted automatically to any investment falling into one of the designated categories. An approval process, however, apparently still applies for Free Zones investments, as a procedure is organized by the law to challenge eventual rejections. Law 8, Article 31.

2.24 Specific Investment Incentives Laws: Tourism Sector and Geographical Development Laws.

a. The Hotels and Tourist Constructions Law.

Law 1 of 1973, as amended, also known as the "Hotels and Tourist Constructions Law," governs investments in the tourism sector.

Besides setting forth general provisions regulating tourism activities, Law 1 also used to include tax incentive provisions for investments in the tourism sector: (1) a five-year exemption from the Tax on Industrial and Commercial Activities[17]**;** (2) a five-year exemption from the Tax on Movable Assets[18]; and (3) an exemption of customs taxes on all imports needed for the investments[19]. These investment incentive provisions were repealed by the new investment law, Law 8, and replaced by the set of incentives defined under this law, since tourism activities are now covered by Law 8. Law 8, Promulgatory Decree, Article 4; Law 8, Article 1. The rest of the provisions of Law 1 remain in force.

b. The New Urban Communities Law.

Law 59 of 1979, also known as the "New Urban Communities Law," was enacted to encourage the development of specific geographic regions of Egypt. Investments made in new urban communities were granted specific tax incentives: (1) a general exemption from the Tax on Industrial and Commercial Activities[20]; (2) a ten-year exemption from the Tax on Movable

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[17] This is the former denomination of the tax on industrial and commercial-source income. Since Law 187 of 1993, this type of income is taxed under the Unified Tax for individuals and the Tax on Profits of Stock Companies for corporations.

[18] Both exemptions from the Tax on Industrial and Commercial Activities and the Tax on Movable Assets were extended to ten years for investments made in remote areas, as defined by the law.

[19] Law 1, Articles 5 and 6. Apparently, the customs taxes exemption was subsequently modified as Law 8 repeals Articles 5 and 5b is and does not mention Article 6.

[20] It is not clear from the English translation of the law whether the exemption was for an indefinite period of time or limited to ten years, like the exemption on dividends.

Capital, completed by an exemption on dividends for the same period; (3) a ten-year exemption from the General Income Tax on Revenues[21]; and (4) a ten-year exemption from property taxes. The investment incentive provisions listed above in (1) (2) and (3) have been repealed by Law 8 and replaced by a new set of incentives defined by Law 8 for investment projects in the new urban communities. Law 8, Article 4 of the Promulgatory Decree; Law 8, Article 16. However, the exemption listed in (4), for property taxes, was not repealed and presumably still applies.

c. The Desert Land Law.

Law 143 of 1981, also known as the "Desert Land Law," was enacted to promote the rehabilitation and development of such land, in particular for agricultural purposes. The law and its Regulations set forth detailed rules and procedures that regulate desert land investment projects, but also provide tax incentives. These incentives are in general similar to those granted for investments made in tourism activities and the new urban communities, *i.e.*, (1) a ten-year exemption from the Tax on Commercial and Industrial Activities, (2) an exemption from taxes on interest income from loans used to finance desert investments, (3) a five-year exemption from custom taxes on imports, and (4) a property taxes exemption. Law 143 Regulations, Article 10 through 16. Still, while the incentives provisions of the Tourism Law and the New Urban Communities Law were repealed and replaced by the similar benefits of Law 8, no such repeal took place for the Desert Land Law provisions[22]. Thus, apparently, the incentive provisions of Law 143 still apply to desert land investment projects.

In addition, Law 143 was completed in 1996 by Law 5 on the Disposal of State-Owned Desert Land. Under **Law 5 of 1996**, investors can acquire ownership of desert land free of charge or lease such land for a nominal fee for up to 40 years renewable. If the project is not implemented or production started within a certain time-period, the land is repossessed by the State.

2.3 Related Legislation.

Other legislation affects investment incentives. Commercial law, labor law, social security law, tax law, capital markets law, intellectual property law, and also the regulatory and judicial framework in general will be taken into account by a potential investor.

2.31 Commercial Law.

As is the case in other Romano-Germanic systems of law, the basis of Egypt's commercial law are set forth in two main codes: The **Civil Code of 1948** and the **Commercial Code of 1883**. These codes contain the main legal principles governing contracts, formation of companies, bankruptcy and securitization. They are thus essential instruments in business transactions. Although an updating of certain provisions of the codes has taken place in recent

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[21] The General Income Tax on Revenues (IGR) was the denomination of the income tax on individuals at the time. This tax has been reorganized and relabelled the Unified Tax by Law 187 of 1993.

[22] See Law 8, Promulgatory Decree, Article 4.

years, for example Law 95 of 1995 addressing leasing transactions, it is generally considered that both codes need a comprehensive modernization.

2.32 Labor Law.

Law 137 of 1981, as amended, together with some sections of the Civil Code and the Companies Law, contains the main provisions governing the relationship between an employer and an employee in Egypt. The law is very detailed. Its essential characteristics are as follows:

- Requirement of a written contract, although an employee can establish his status by other evidence;
- Working hours are regulated and overtime must be compensated;
- Minimum wages, holidays, paid vacations and sick leave are regulated;.
- Employment agreements can be terminated only in accordance with the conditions and procedures set forth in the law;
- Workers must be represented in the management of the company and are entitled to a ten-percent share of the distributed profits.
- Employment of expatriates is generally restricted. Expatriates employees must not exceed ten percent of all employees. Training of an Egyptian counterpart is compulsory;
- A government agency, the Labor Office, is in charge of supervising all issues arising from an employer/employee relationship.

In short, the law is not as permissive as in some other countries, the U.S., for example, and employment relationships are closely monitored by the state. As discussed above, Law 8 companies are exempt from certain labor law requirements.

2.33 Social Security Law.

Law 79 of 1975, as amended by Law 25 of 1977 and Law 47 of 1984, is the main Egyptian Social Security law. Social Security contributions are levied on both Egyptian employees and employers for medical coverage and retirement. Social Security laws do not apply to expatriates. Employees' contributions are withheld at the source on a monthly basis. The contribution rates are subject to ceilings and are as follows:

(1) On annual salary up to LE 3,600; Employer: 26.0; Employee: 14.0
(2) On annual salary from LE 3,600-9,600: Employer: 24.0; Employee: 11.0

As discussed in footnotes above, contrary to a statement made by the Ministry of Economy in a recently published brochure, Law 8 companies are subject to the general social security retirement scheme for Egyptian employees. In addition to the general retirement plan, not in substitution to the general scheme, Law 8 companies are free to offer an additional pension plan. A substitution plan is allowed only for medical coverage. Within certain limits, all private companies can decide to organize their own health insurance plan for employees.

2.34 Tax Law.

The main features of Egypt's corporate taxation have been discussed above in the section devoted to the description of the Tax Code's investment incentives. Other aspects of the tax law in general also affect prospective investments. These aspects are discussed below:

- **Taxes on salaries.** Egypt does not have any payroll taxes. At the employee's level, salaries and wages are subject to the Unified Income Tax under a separate schedule. The tax is withheld at the source. The tax rates are: 20 percent on taxable income up to LE 50,000 and 32 percent on taxable income over LE 50,000. Income in excess of LE 18,000 is subject to an additional two percent development tax.

- **Business tax.** Egypt currently does not have a specific business tax.

- **Taxes on dividends and royalties payments.** There are no withholding taxes on dividends if the company paying the dividend carries on an activity in Egypt and is subject to corporate income taxes. Royalties payments are subject to a 32 percent withholding tax on the gross amount plus a two percent development tax when the amount exceeds LE 18,000 annually.

- **Taxes on goods and services.** A specific law, **Law 11 of 1991**, completed by several decrees[23], governs Egypt's indirect taxation. A general sale tax (GST) is levied on imported and domestically produced goods and services. Various exemptions apply. Input credit can be obtained only by registered firms and solely for goods. The rates range from five percent to 25 percent with most goods subject to the standard ten percent tax on gross sales.

- **Real property taxes**. Real estate taxes are levied on the assessed annual rental value of land and buildings. Some deductions are allowed for maintenance and other expenses. The rates range from ten percent to 40 percent.

- **Tax treaties.** Egypt has a wide network of tax treaties. Tax treaties are important tools in attracting foreign investments. Bilateral tax treaties have been concluded with the following countries: Austria, Canada, Denmark, Finland, France, Germany, India, Iraq, Italy, Japan, Libya, Norway, Romania, Sudan, Sweden, Switzerland, Syria, Tunisia, United Kingdom, and the U.S. Tax treaties are also being prepared with Armenia, Bahrain, Belarus, Cyprus, Indonesia, South Korea, Malaysia, Malta, Mongolia, Morocco, the Netherlands, Oman, Pakistan, Poland, Russia, and Yemen.

2.35 Capital Market Law.

[23] Decrees 180 of 1991, 295 of 1993, 304 of 1993 and 39 of 1994.

Law 95 of 1992 on the Capital Market, together with its Executive Regulations, is now the fundamental law governing public offering of shares and the Stock Exchange.

A detailed analysis of Law 95 is not within the scope of this study[24]. The following points, however, would be important to a prospective investor:

- In many respects, the provisions of Egyptian law relating to publicly traded companies are modern and comparable to existing legislation in the U.S. or Europe. In particular, publicly traded companies are required to publish financial data and other information[25]. Protection of minority shareholders is well organized through compulsory notification of certain transactions and also requirements that minority shareholders have the right to be bought out in case of take-over bids[26].

- A state agency, the Capital Market Authority (CMA), is in charge of overseeing the capital markets. The CMA is organized along lines similar to the U.S. Securities Exchange Commission and the French Commission des Operations de Bourse. The CMA is entitled to a strong control of companies operating in the field of securities, *i.e.*, banks, brokers, mutual funds.

- Two stock exchanges presently exist in Egypt: the Cairo Stock Exchange and the Alexandria Stock Exchange. Most of the companies are in fact listed on the Cairo Stock Exchange. The market is active and has seen a rapid expansion during the past few years[27].

2.36 Intellectual Property Law.

- **Patents.** Law 132 of 1949, as amended, on Patents and Industrial Designs, generally provides a 15-year protection to inventors. Although an additional five years is allowed, this law is generally considered outdated. An updating of the law has been undertaken.

- **Trademarks.** Under Law 57 of 1939 (the Trademark Law), trade names and trademarks are protected for a 10-year period, renewable indefinitely. As is the case for the Patent Law, a revision of the Trademark Law is being considered.

- **Copyrights.** Copyrights are protected under Law 354 of 1954, as amended. Following major amendments in 1992 and 1994, the law offers better protection against piracy, and copyright protection was extended to computer software.

2.37 Other Regulations.

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[24] For such an analysis, See: "Legal Analysis of Sale of Shares" prepared for USAID-Cairo, January 1995, Pierre Gianni-IBTCI.
[25] See Law 95, Article 6, completed by the Executive Regulations, Article 58.
[26] See, in particular, Law 95, Article 8; also Law 95 Executive Regulations, Article 59 and 61.
[27] The Cairo Stock Exchange was in 1955 the world's 5th most active market.

- **Exchange control.** A 1994 amendment (Law 38 of 1994) to the Foreign Exchange Law, Law 79 of 1979, has relaxed government control on capital transfers. Apparently, no restrictions currently apply to companies for transfers of funds in or out of Egypt.

- **Customs.** Several laws govern customs taxes. The basic law is Law 66 of 1963. The Customs Tariff is based on the Brussels Tariff Nomenclature. All duties are ad valorem and are assessed on a fair market price. Various exemptions apply. A drawback regime exists for goods reexported within one year after the duties were paid. Rates mainly vary between five percent and 70 percent, with most industrial supplies in the five to 20-percent range.

- **Restricted activities.** Restrictions apply to certain activities. A significant aspect of Egypt's current economic law is that the importation of goods for the "purpose of trade" (resale) can be carried out only by Egyptian nationals or companies wholly owned by Egyptian nationals[28]. This rule is considered by foreign investors as a serious impediment to the development of their distribution operations in Egypt.

2.38 Judicial System.

The judicial system is an essential component of the legal framework affecting private investment. Extensive studies[29] performed in recent years have been critical of the functioning of the judicial system.

- The enforcement of commercial laws has been analyzed as inefficient, dilatory and ineffective.

- The difficulties and the high costs of enforcing judgments have been underlined, as well as the lack of resources of the judiciary.

3.0 Analysis of the Legislation

3.1 Recent Changes.

3.11 Law 159.

In many respects, Law 159 can be considered a modern corporate law, in particular regarding shareholders' rights.[30] Its shortfalls are mainly inherent in (1) its civil code system of law origins, where detailed statutory requirements are the norm; (2) its administration in an environment still tainted by the bureaucratic approach of twenty years of socialist economy; (3) its overlap with other legislation; and (4) the poor English translation of the law that makes it

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[28] We were not able to locate the reference of the law or decree that sets forth this condition. Trade law practitioners confirmed however, that this restriction was currently still in force.
[29] See, in particular, "Egyptian Legal and Judicial Sector Assessment", prepared for USAID-Cairo, February 1994, John Bentley.
[30] For a detailed analysis of shareholders' rights under Law 159, see "Legal Analysis of Sale of Shares", Op. cit.

appear more confusing than it really is. Still, Law 159 does not reflect all recent trends and simplifications that have taken place in other countries with a similar corporate law basis, and an extensive revision of the law is underway. The lengthy process of incorporation and the rigidity of certain statutory requirements in particular have been identified in recent studies[31] as potential disincentives to private investment. Steps were recently taken by the Government of Egypt (GOE) to remedy quickly some of those shortfalls with the enactment of Law 8 of 1998.

Law 3 of 1998[32] is a significant step towards the modernization of the law and the streamlining of the incorporation process.

- **Incorporation process.** Prior to the enactment of Law 3, as part of the incorporation process, a new company's contemplated activities were subject to a "security check" from the Companies Authority. This security check had been identified in prior studies as one of the main causes for the lengthiness of the incorporation process.[33] Under Law 3, such approval of a company's formation appears necessary only for certain sensitive activities, *e.g.*, activities undertaken in the field of satellite communications, newspapers, and remote sensing systems. Law 3, Article 1 modifying Article 17 of Law 159. Otherwise, upon receipt of the articles of incorporation, and a statement that the initial cash contribution to capital has been deposited in a bank, plus a proof of payment of the fee on incorporation, the Companies Authority must provide to the founders a document allowing the registration of the new company with the Registry of Commerce. The law emphasizes that no other conditions or procedures are required, regardless of the percentage of participation of non-Egyptian nationals in the capital of the company. Further, the power of the Companies Authority to object to a company's formation is restricted to three situations: (1) violation of Law 159 provisions; (2) violation of public order; and (3) if the founders do not have the legal capacity to form a company. Law 8, Article 1 modifying Article 18 of Law 159. This objection by the Companies Authority must intervene within ten days of the deliverance of the document discussed above. This is a significant improvement on prior law, as, in principle, a control *a posteriori* has replaced the former *a priori* control. In other words, there is a presumption that the documents provided by the founders to the Companies Authority are correct[34]. Apparently, Law 3 has been very successful in shortening the time period required for incorporation. Comments we received from corporate law practitioners stressed that the delay required for incorporation was reduced from approximately three months to three weeks or less.

- **Statutory requirements.** Law 3 also includes provisions to facilitate the formation of a company with respect to minimum capital paid-up requirements. Under the new law, the minimum paid-up capital has been reduced from 25 percent to ten percent. However, this ten-percent amount must be increased to 25 percent within three months of the formation of the company. The balance of the shares must be paid within five years. Law 3, Article 1

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31 In particular, IFC/FIAS, "Study of Impediments to Private Sector in Egypt," Dec. 1997.

32 Completed by two implementation decrees: Decrees 25 and 75 of 1998.

33 About two months to complete and involving 50 to 80 percent of the total time required for registration. IFC/FIAS, Op. cit.

34 The exact same change took place in France when corporate law was modernized in 1966.

modifying Article 32 of Law 159. Under prior law, the balance of the shares had to be paid within ten years. In our view, this is a minor improvement.

Criticisms have also been made about Egypt's corporate law requirement of minimum issued capital. This requirement has been viewed as a disincentive to private investment. We do not believe that this requirement is really a significant impediment because: (1) similar requirements exist in other European corporate laws and do not prevent investments; (2) considering the weaknesses of Egypt's judicial system, the minimum capital requirement acts as a protection for creditors; and (3) Egypt allows the undertaking of business activities in a corporate form with a low minimum capital requirement (the Limited Liability Company where the minimum capital required is only LE 50,000).

According to prior studies[35], the rigid format of the articles of incorporation is an impediment to private sector investment, since a simple modification to the articles stating the purposes of a company requires another lengthy review by the Companies Authority to verify compliance. We agree that this should not be the case. In most countries, the articles of incorporation addressing the purposes of a company are generally drafted in a very broad way to include all activities connected to the main purpose. Presumably, with the enactment of Law 3, this post-incorporation review by the Companies Authority should be reduced to the same type of control required by the law when the company is formed, *i.e.*, a control that the required documentation is produced. If that is not the case, the issue should be addressed by specific instructions to the Companies Authority.

- **Other.** Law 3 also further liberalized the shareholder's rights to distribute all or part of after-tax profits (Law 3, Article 2 modifying Article 40 of Law 159) and the rules regarding the floating of stock (Law 3, Article 1 modifying Article 37 of Law 159).

3.12 Capital Market Law.

In addition to the provisions of Law 3 amending Law 159 for publicly traded companies, discussed above, several regulatory measures were taken in recent years by the GOE to modernize capital markets legislation.

- Companies are allowed to buy back their stock for distribution to employees or to prevent excessive price fluctuations on the stock market (Treasury Stock). In addition, publicly traded companies' provisions regarding shareholders' information rights and meetings were updated. **Decree of the Minister of Economy 75 of 1998** enforcing certain provisions of Law 3 of 1998 concerning the amendment of certain provisions of Law 159.

- **Law 158 of 1998** amended Law 95 of 1992 to allow the replacement of certificates representing shares by inscriptions in registers kept by the issuing corporations or inscriptions with a "Central Depository" (a clearing house, equivalent to the U.S. Depository Trust Company or the French SICOVAM).

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[35] IFC/FIAS, Op. cit.

- **Decree 39 of 1998,** by the Minister of Economy issued a new code of conduct for mutual funds and brokers.

- Guidelines were published by the GOE on **International Accounting Standards** to be used by publicly traded companies.

- An **extensive revision** of all the legislation pertaining to the organization and functioning of the capital market is under way. Two U.S. international law firms with experience in drafting emerging markets securities laws have been contracted to provide technical assistance with the reform.

3.13 Tax Code.

Beside the **major reform of Law 187 of 1993,** previously discussed, that prepared the move of the Egyptian tax law from a schedular system of taxation towards a modern "Global Tax" system, several reforms have been aimed at simplifying and updating Egypt's tax law. The main revisions are as follows:

- **Law 11 of 1996** repealed the stamp tax imposed on the initial capital of companies and on capital increases.

- **Law 89 of 1996** suppressed the two-percent capital gain tax previously levied on the sale of securities.

- **Law 90 of 1996** amended the provisions of the Unified Tax Law to exempt from income tax dividends distributed by mutual funds operating in Egypt.

- **Law 91 of 1996** amended the provisions of Law 111 of 1991 on the sales tax to facilitate the payment of the tax.

- **Law 226 of 1996** amended the Tax Code to exempt from income tax mutual funds operating in Egypt.

- **Law 227 of 1996** abolished inheritance taxes.

In addition, a major tax reform project is underway with the assistance of international organizations, *i.e.*, the International Monetary Fund and the World Bank. This reform will aim at (1) broadening the tax base and (2) simplifying the different rates and schedules, presumably with a decrease of the general corporate and individuals rates.

3.14 Law 8.

Law 8 of 1997 is Egypt's fourth investment law since 1971, the year that marked the beginning of a new economic policy. The provisions of the new law are compared below to those of the former investment law, Law 230 of 1989.

- **Scope.** The scope of the new law is clearly defined. Law 8 applies only to investment projects undertaken after its enactment, *i.e.,* May 12, 1997. Investments made under Law 230 are still governed by that law and keep the benefits of its investment incentive provisions until the normal date set for their expiration. Law 8 and Law 230 will thus coexist for a certain number of years.

- **Qualifying activities.** Qualifying activities under Law 8 are **targeted.** Under Law 230, qualifying activities were broadly defined, *i.e.*, reclamation and cultivation of desert land, industry, tourism, housing and reconstruction[36]. Under Law 8, only sixteen specific types of activities can have the benefit of the investment incentive provisions. Whether this targeting has resulted in a broader coverage of investment sponsored activities is not obvious. Criticism has been made of the fact that activities previously covered under Law 230 now cannot benefit from Law 8 investment incentive provisions, *e.g.*, road transportation of goods.[37] The exclusion of certain activities related to exports, *e.g.*, marketing, advertising and trading in general has also been criticized. Still, it has been generally agreed that the targeted approach of Law 8 is an improvement over Law 230, as it provides a clearer definition of the coverage and thus (1) is less prone to arbitrary decisions by government authorities and (2) it prevents abusive extension of the law beyond what was intended by the government[38].

- **Minimum investment.** No conditions of minimum investment are set under Law 8. This approach was also the approach retained under Law 230. The fact that no minimum investment is required will likely result in a large number of business entities being entitled to the benefits of the law. Presumably also, a significant portion of those entities will be small and medium-size businesses. One can question whether those small and medium-size businesses will create employment opportunities or generate resources worth the tax benefits they receive. In our experience with investment laws in developing countries, they generally require a minimum investment in capital, or set conditions in terms of jobs created. The absence of minimum investment requirements may be the result of a conscious decision of the GOE to create and develop a network of small and medium-size private enterprises badly needed after twenty years of socialist economy.

- **Type of entities.** Under Law 8 as under Law 230, all types of business entities, including sole proprietorships, can benefit from the provisions of the new law. Presumably, as discussed just above, this approach may have been taken to encourage the development of all components of a private sector economy.

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[36] Law 230, Article 1. Various activities were, however, later added by specific decrees of the Prime Minister, i.e., service and maintenance for heavy vehicles, water pumping stations, services related to oil production (Decree 22 of 1991), technical consulting and transportation activities (Decree 1344 of 1991), medical services (Decree 1293 of 1992), marketing and securities management activities (Decree 2612 of 1994).
[37] Only refrigerated transport is covered. Law 8, Article 1.
[38] Especially in the service sector. Compare the broad coverage of Law 230 ("tourism") with the restricted definition under Law 8.

- **Supervisory government agency.** Under the provisions of Law 8, a specific government agency was to be created to supervise the administration of the benefits of the new law. To date, this agency has not been created and the government agency in charge of administering Law 230, the GAFI, is authorized to operate in the interim. Apparently, during the drafting of Law 8, an attempt was made to provide for a single authority to supervise both Law 159 companies and Law 230/8 companies. These efforts fell short and it is likely that a decision was made not to force a resolution of the issue and leave it to be worked out in later times.

- **Law 8 companies.** As a result of the absence of a single authority for administering companies, there is not yet a unified route for forming such entities. Companies can still be formed either under Law 159 or under Law 8. The incorporation processes, however, are similar and only certain provisions of Law 159 do not apply to Law 8 companies[39]. The GAFI is substituted for the Companies Authority in applying Law 159 provisions to Law 8 companies. Besides not being subject to certain provisions of Law 159, Law 8 companies also are not governed by the compulsory provisions of Law 73 of 1973 calling for employees to be represented on the boards of directors of companies. In addition, a prospective investor should note that Law 8 did not repeal Article 20, paragraph 3, of Law 230. This provision gives employees of a company a compulsory ten-percent share of distributed profits. This requirement thus still applies to Law 8 companies.

- **Approval process.** A major difference between Law 230 and Law 8 is that, in principle, there is no approval process under Law 8. According to the Law, Article 27, and its Executive Regulations, Article 19, the benefits of the new law are granted automatically to any enterprise that plans to operate in one of the sectors covered by Law 8. GAFI's managing authorities assured us verbally that this automatic approval process set by the law was also the case in practice. A simple notification to the GAFI of the start and the nature of operations is required, and after ascertaining the truthfulness of the data provided, the GAFI normally delivers a certificate stating that the benefits of Law 8 have been granted.[40] Criticisms have been made of the absence of substantive provisions in the approval process. They emphasized that this could lead to arbitrary decisions. In our view, this absence of detailed requirements and procedures is, instead, a positive step, as (1) it will shorten the time period required to establish businesses and (2) it will avoid bureaucratic decisions in the process. We do not think that the risk of arbitrary decisions is increased, in this particular situation, by the absence of detailed provisions. It is more important, in our opinion, that the Agency in charge follows and respects the liberal approach of the law, which is apparently the case now.

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[39] Law 8, Article 14 excludes the application of articles 17, 18, 19, 41, 71 (first and fourth clauses), 83, 92 and 93 of Law 159. Articles 17, 18, and 19 of Law 159 relate to the Companies Authority supervision. Article 41 refers to the compulsory distribution of a share of profits to employees. The first and fourth clause of Article 77 and Articles 83 and 93 restrict in various ways the conditions set for the election and representation of Board's members. Article 92 had been already canceled by Law 3 (!).

[40] Law 8 Regulations, Article 20.

- **Tax incentives.** One of the main goals of Law 8 was to consolidate the various exemptions that were set forth by several investment laws. As discussed before, Law 8 did achieve this result with respect to the Hotel and Tourists Constructions Law and the New Urban Communities Law. The same exemptions now apply under Law 8 and the two aforementioned laws, and this for similar periods of time. The Desert Investment Law provisions have not, however, been consolidated by Law 8.

  In addition, Law 8 introduced some changes to the tax incentives, compared to those under Law 230. These **changes are generally not major**, *i.e.*,

  (1) Under Law 230, the exemption period could be extended by two years for investments made with more than 60 percent domestic inputs[41]. A similar provision was not included in Law 8, perhaps for simplification purposes.

  (2) Another difference is that under Law 230 the maximum exemption period available was seventeen years.[42] Under law 8, this maximum is raised to 20 years (for investment outside the Old Nile Valley).[43]

  (3) Under Law 230, a 25 percent exemption from inheritance taxes existed for funds invested in qualifying projects[44]. There is no similar provision in Law 8, as inheritance taxes were repealed by Law 227 of 1996.

  (4) Under Law 230, the exemption from the Stamp Tax on contracts was granted until the completion of the project.[45] Under Law 8, the exemption is restricted to the three years following the date of registration with the Registry of Commerce[46].

  (5) Under Law 230, for individuals, a limited exemption from the General Income Tax[47] was allowed for a certain number of years after the termination of the original exemption period. This provision was not included in Law 8.

  (6) Two exemptions that apparently did not exist under Law 230 were added in Law 8, *i.e.*, an income tax exemption for capital gains realized in reorganizations[48] and a similar exemption on capital gains realized on transfers of assets at the time of formation of a new company[49].

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[41] Law 230, Article 11.
[42] Law 230, Article 11.
[43] Law 8, Article 17.
[44] Law 230, Article 13.
[45] Law 230, Article 14.
[46] Law 8, Article 20.
[47] IGR. General Income Tax on individuals. Replaced by the Unified Tax following Law 197 of 1993.
[48] Law 8, Article 25.
[49] Law 8, Article 26.

More important is the fact that under Law 8, additional investments are not allowed the benefits of the law. Under Law 230, additional investments were granted additional time-period exemptions. This absence of incentives for additional investments has been severely criticized in business communities. The unofficial answer of government authorities is that a new entity could be created to house the new project. This answer is not considered satisfactory, in particular by large foreign companies that are usually subject to numerous requirements to form new entities. Admittedly, the problem is not easy. Exemptions for additional investments would require definitional provisions regarding the type or volume of investments justifying further exemptions, an issue that the law tried to avoid in the first place, as no specific conditions are indeed set for the initial investment. A solution needs to be found to this issue, as the unofficial answer offered by the government authorities is not a rational solution.

- **Investment guarantees.** The guarantees against nationalization and sequestration provided by Law 8, as well as its affirmation of the rights of foreigners to own land were already stated in Law 230. Similarly, the possibility to allocate land to certain investors[50] **was already part of the provisions of Law 5 of 1996.**

  Law 8 did introduce a significant change in the guarantee provisions however. It relates to the ability of companies to determine freely the **market prices** of their products. Under Law 230, the government could decide under certain circumstances to fix prices arbitrarily. No similar provision is set forth in Law 8. According to some legal commentators, apparently the government did not claim the right to interfere in market prices in order to demonstrate its commitment to a free-market economy.

- **Free Zones.** No major difference is apparent between Law 8 and the former investment law regarding the Free Zones legislation. Law 8 provisions are similar to those of Law 230, the provisions of which, in turn, substantially reflected the provisions of Law 43. As was the case under Law 230, the Free Zone legislation is a separate part of Law 8 and is essentially organized along the same lines. We note, however, the following points:

  (1) Substantive provisions of Law 230 (Part Four) were devoted to the organization and the powers of the **GAFI**. Under Law 8, there is not such a comprehensive (nor specific) section of the Law addressing the powers of the Agency To-Be-In-Charge. Further, as this Agency has not been created, and since the provisions in Law 230 regarding GAFI have been abrogated by Law 8[51], an incertitude exists regarding GAFI's authority, particularly with respect to the granting and revocation of Free Zone licenses.

  (2) In Law 8 as in Law 230, the conditions for admission to Free Zone status rest mainly with the Agency in charge of the Free Zone. In particular, no requirement of minimum export sales is apparent in the laws, except for an indirect reference in Article 29 of Law 8

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50 Law 8, Article 28.

51 Law 8 repealed Law 230 in its entirety, except for the third clause of Article 20 pertaining to the distributive share of profits to workers.

Regulations (exports shall not be less than half the production) in the particular case of companies converting their operations from inside Egypt to a private Free Zone. This lack of definitional requirements in the law is surprising, as free zones requirements could then vary from one zone to another. In practice, however, the requirements for admission to Free Zone status are apparently similar for all free zones, except that non-industry related activities may be allowed more liberally, depending on the availability of physical space inside a particular zone.

(3) There are two types of free zones. "Public" free zones, where several companies are established, and "private" free zones devoted to a specific project or company. Currently, several free zones are operational with investments from major international companies and Egyptian companies as well. The second part of this report, Economic Considerations, discusses these investments in detail. On the legal side, with respect to the lack of detailed admission requirements in the law, it should be noted that the GAFI does not grant licenses indiscriminately to operate within the free zones. Free Zone status is apparently granted only to certain companies, with a consideration of the economic benefits that such a status will bring Egypt.[52] This issue is also discussed in detail in the second part of this report.

3.15 Related Legislation.

While it is beyond the scope of this study to undertake a detailed analysis of all the recent changes that may affect investments in Egypt, it is useful for the purpose of this activity to present, even briefly, a summary of the **main new laws** that have been passed recently by the GOE **to facilitate** in various ways **private investment**.

In addition to the various laws discussed above, we have noted, in particular, the following texts:

- Prime Minister Decree 11 of 1996, simplifying procedures for implementing the flat five-percent tariff on equipment imported for tourism projects
- Prime Minister Decree 314 of 1996, organizing offices in the Governorates to assist investors
- Law 21 of 1996, allowing private sector companies to engage in maritime transport activities
- Law 94 of 1996, exempting ocean vessels from customs taxes and sales taxes
- Law 101 of 1996, facilitating the licensing process for general contractors
- Law 223 of 1996, streamlining the documentation required for notarization

[52] The Egyptian Gazette announced on December 11, 1998 that Decree 619 of the same date, issued by the Ministry of Trade, will restrict the importation of foreign goods into Egypt. On this occasion, GAFI authorities stressed that free zones should not been viewed as a way to import tax-free foreign goods for resale within Egypt. Further emphasis was put by the GAFI authorities on the export-oriented purpose of the free zones.

- Law 224 of 1996, reducing notarization fees by 50 percent

- Law 231 of 1996, suppressing the permit requirement for Egyptian nationals employed by foreign organizations and simplifying the notification process

- Law 97 of 1996, allowing foreign ownership of banks and liberalizing banking activities

- Law 155 of 1998, opening state-owned banks' capital to private investors

- Law 156 of 1998, allowing 100-percent foreign ownership in insurance and reinsurance activities

3.2 General Assessment.

As a general conclusion to this presentation of investment incentive legislation passed by the GOE in recent years, the following points should be emphasized:

- Without doubt, **very strong efforts** have been made by the GOE to promote and facilitate the development of private investment in Egypt. These efforts have not been aimed solely at Egyptian nationals but also at attracting foreign investors. The number of laws passed in recent years and their content is a testimony to these efforts.

- Significant progress has been made in several areas, particularly with respect to the streamlining of business establishment and the simplification of administrative procedures in general. **Improvements** are still needed, particularly in the area of commercial law, corporate law, taxation, and the administration of the law in general. Steps are being taken by the GOE in these areas. Several projects are under way to **unify the legislation**, as most of the reforms to date have been "piece-meal" and not comprehensive.

- Whether the incentives granted under current legislation are **cost-effective** is a question that cannot be answered solely from a legal point of view. The macro-economic analysis developed in the second part of this study attempts to provide answers to that question. However, from a tax and legal standpoint, the following comments can be made:

  Tax incentives do attract investors. **Other factors,** like infrastructure, markets, and availability of labor, usually outweigh tax considerations.

  Tax incentives have a cost, the foregone revenues. **Facilitating laws**, updated legislation, and flexible administrative procedures do not have such a cost. Undoubtedly, the **privatization process** launched by the GOE has played a major role in this area.

  For foreign investors, tax incentives work only if the country of origin of the investor does not tax the investor's profits when they are repatriated, an issue known as "**tax sparing.**"

Recent discussions within OECD countries have shown an emerging consensus that the minority view of the U.S.[53] **may be more generally accepted in the near future.**[54]

Egypt's present array of tax incentive provisions **may need to be rationalized.** The investment incentive provisions of the Income Tax Code have little weight compared to the indefinite tax holidays under Free Zone status or the five-, ten-, or twenty-year tax exemption allowed to Law 8 companies. If the requirements set for Free Zones or Law 8 status are too light, there is a risk that a growing number of enterprises currently operating under normal tax law will want to obtain the benefit of tax-free status, to the detriment of tax revenues.

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[53] The U.S. tax policy is strongly opposed to providing tax-sparing credits

[54] "Tax Sparing: A Reconsideration" OECD, March 1998, cited in "Treaty Tax- Sparing Credits," by William J. Martin, Esq., Tax Notes International, Sept. 1998

4.0 Assessment of Cost Effectiveness

4.1 Conceptual Issues

Cost effectiveness assesses the cost related to the benefits of a project or a program. The cost is mainly the tax revenue lost to the GOE by granting fiscal incentives to sectors eligible to receive them. There are indirect costs associated with the granting of investment incentives, such as the interference with the efficient operation of market forces and distortion of competition.

Investment incentives may encourage diverting capital from more productive to less productive uses. In many cases, however, investment incentives help augment the total amount invested by stimulating more investments and more capital inflows from abroad.

Governments attempt to attract investments to specific sectors by offering fiscal incentives, which are a form of subsidy designed to improve the bottom line of targeted companies. Investment incentives benefit specific activities, sectors, or companies and can affect investment decisions and stimulate investments by companies receiving incentives. By temporarily reducing or eliminating a major tax component for a company, its competitiveness can be improved compared to imports or domestic products of companies not privileged to receive incentives. This distortion of competition can lead to reduced investments by the non-privileged companies. Thus fiscal incentives are discriminatory against companies, activities, or sectors that do not qualify for the incentives.

Investment incentives are strategies employed by governments to help attain a set of objectives for economic development. These objectives can relate to export development, job creation, strengthening and expanding the private sector, attracting foreign investment, capital and technology, import substitution, development of specific industries, opening new areas for economic development, or pursuing other policies.

Cost effective analysis assesses the costs and benefits of various alternatives to determine the least cost relative to the benefits of achieving a given set of goals. This analysis is appropriate where different strategies can be compared for reaching a given objective.

Cost effectiveness can best be assessed if complete and reliable data are available to measure the costs and benefits associated with a project or program. Where all the benefits cannot be measured, because data are not available, the analysis is often reduced to a least cost analysis. This approach does not assess cost effectiveness, because the benefits of alternative strategies to attain a given objective are not considered and are not measured against the associated alternative costs.

4.2 Comparisons of Qualitative Factors in the Cost Effectiveness of Egypt's Investment Incentives

A thoroughly adequate quantitative assessment comparing the cost effectiveness of Law 8 with previous investment incentive laws cannot be undertaken at this time, because Law 8 started operating only after May 11, 1997. The time elapsed is too short for investments approved for incentives under Law 8 to be completed, to enter production, and to generate at least one tax year of profits, with all multiplier effects on production, employment, income, profits, and tax payments of supplier firms and service providers to the tax exempt investments.

Still, an effort has been made in this study to use available data and other relevant information for assessing and comparing the cost effectiveness with previous legislation wherever possible, and arriving at meaningful conclusions. The statistical results tend to have an upward bias in favor of positive investor responses to investment incentives, because the published GAFI database used in this study shows planned rather than actual investment and employment data.

Law 8 specifies the areas of activity eligible for investment incentives. The approval process is now mostly automatic, streamlined, and greatly speeded up. Under previous legislation, eligibility and approval were highly uncertain and the approval process quite lengthy and complex. These reforms can be considered a qualitative improvement in cost effectiveness.

The administrator of the approval process, namely GAFI, retains the right to intervene and interrupt the automatic approval process in certain cases where the vagueness of the law invites abuses or undesirable results. This intervention is being currently exercised by refusing licenses to new investments in the free zones for purposes of merely warehousing imported goods for entry into Egypt. The cost effectiveness of investment incentives for import operations through the free zones is highly negative, because the government foregoes permanently income tax revenue on profits from imports. Clearly, it was not the intent of the law to grant permanent tax holidays to Egyptian companies running import operations in the free zones. The problem obviously lies with the terms relating to free zone investments in Law 8.

Currently, most investment incentives fall under Law 8 and some under Law 159. Previously, several laws overlapped in offering investment incentives. Concentration of investment incentives under two laws instead of several improves the efficiency of administration. This can be considered another qualitative improvement in cost effectiveness.

The periods of tax holidays for specified activities have been left largely unchanged in Law 8 compared to previous laws:

- Permanent exemption for profits of firms located in designated free zones;
- 20-year exemption of profits from investments outside the Old Valley;
- 10-year exemption of profits from investments in new industrial zones, in new urban communities, and in designated remote areas; and
- 5-year exemption of profits from new investments in activities listed in Law 8.

The automatic eligibility and approval process under Law 8 removed the strong discretionary power and arbitrariness of the approval authority under the earlier legislation. This is a distinct qualitative improvement in cost effectiveness highly valued by foreign investors.

The automatic approval process of Law 8 incentives administered by GAFI replaced a costly, cumbersome, long approval process by high level committees -- clearly a saving of time and money for the government, freeing up officials to deal with other government matters. This, too, can be considered an improvement of cost effectiveness.

Under Law 8 a company is generally certain that its new investment will be automatically eligible for investment incentives if it falls within the 16 categories specified in the Law. Under previous legislation, new investments had to meet vague criteria to be eligible. These criteria were often difficult to determine and to measure and hard to monitor, thereby providing incentives for circumvention. This set of problems has been reduced, which can be considered a plus for the cost effectiveness of Law 8.

Law 8 does not provide for extensions of the original period of tax incentives, even for new investments related to privatizations or expansion of investments, while previous laws allowed it. In other words, with Law 8 the authorities consider that investments should become competitive and viable without additional incentives at the end of the incentive period and start paying corporate taxes on their profits, except in the case of investments located in the Free Zones. This general provision in Law 8 enhances its cost effectiveness relative to previous legislation.

Opportunities for circumvention of the intent of the law 8 have been reduced, but not eliminated under Law 8. Companies can continue receiving fiscal incentives by forming new companies when they expand their investments or build new plants. They can even discontinue subsidiaries while creating new ones with the same or expanded fixed assets. Such a corporation would then be eligible for a new period of investment incentives. Such circumvention to prolong fiscal benefits, if not disallowed, is a negative element for the cost effectiveness of Law 8.

4.3 Sectoral Distribution of Companies with Investment Incentives

Sufficient statistical information is not available at this time to permit a complete analysis of the results of the operation of investment incentives. Data are not available about exports, production, income, and tax effects created directly by the investments benefiting from incentives and indirectly by stimulating an array of ancillary production, contracting, transportation, supplier, financial, legal and other service activities in Egypt.

One measure of the success of investment incentives is the growth in the number of new companies and in the amounts of investment under the incentives program. Actual amounts of investments carried out annually under the incentives program are unfortunately not published or otherwise made available by GAFI. The table below shows planned investments and job creation by companies receiving incentives.

Table 1
Number of Companies, Investment, and Foreign Participation According to Activities Receiving Incentives under Law 8 Compared to Previous Legislation for Comparable Periods

	Number of Companies		Total Investment Costs in LE mill.		Foreign In LE mill.	
	(1)	(2)	(1)	(2)	(1)	(2)
Land Reclamation	**9**	**113**	**205**	**5,457**	**1**	**363**
Agriculture/Fisheries	**33**	**76**	**733**	**367**	**25**	**22**
Industry and Mining	**438**	**1,398**	**11,750**	**17,291**	**1,063**	**774**
Computer & Software	**13**	**106**	**326**	**147**	**53**	**8**
Tourism	**138**	**313**	**7,921**	**12,496**	**678**	**452**
Air Transport	**1**	**8**	**10**	**122**	**0**	**18**
Maritime Transport	**0**	**3**	**0**	**13**	**0**	**0**
Oil Service Support	**4**	**25**	**98**	**1,658**	**12**	**53**
Housing	**0**	**10**	**0**	**163**	**0**	**0**
Infrastructure/Constr.	**4**	**42**	**147**	**7,720**	**24**	**1,434**
Hospitals	**11**	**100**	**113**	**357**	**21**	**16**
Lease Financing	**5**	**19**	**141**	**250**	**24**	**1**
Share Subscript. Guarantees	**4**	**4**	**44**	**20**	**0.1**	**3**
Venture Capital	**1**	**2**	**70**	**280**	**10**	**205**
Soc. Fund for Dev. Projects	**0**	**2**	**0**	**0.3**	**0**	**0**
Total	**661**	**2,221**	**21,557**	**46,341.3**	**1,911.1**	**3,249**

(1) 1/1/1996 - 5/31/1997, incentives under previous laws
(2) 6/1/1997 - 9/30/1998, incentives under Law 8

Source: GAFI, Information Center

The data in the above table show that planned investments under Law 8 significantly accelerated relative to a comparable period under previous legislation. The number of new beneficiary companies formed was 2,221 under Law 8 versus 661 under previous legislation -- an increase of 223%. The total amount of planned investments expanded by 90% and foreign participation by 56%. These increases in planned investments under the incentive programs show that the improved administration under Law 8 has already had an impact in accelerating investments in the economy compared to the earlier period.

Large increases have been recorded in most sectors, but industry, tourism, construction, and land reclamation dominate. There has been virtually no investments in projects under the Social Fund for Development to aid small businesses. Foreign investment attracted by the incentives under Law 8 has increased, but its share in total investment has decreased relative to the comparable period under previous legislation.

Further analysis of data from GAFI indicates that the largest number of companies benefiting from the incentives under Law 8 in the industrial sector were in chemicals (394), engineering (302), and food and beverages (296). In terms of total investment, it was chemicals (LE 7.5 billion), metallurgy (LE 4.1 billion), building materials (LE 3.3 billion), and engineering (LE 2.7 billion).

The following table shows a distinct upward trend annually in the number of companies established in the sectors eligible for investment incentives. The annual total increased 220%, from only 76 in 1994 to 242 in 1996, the last full year of investment incentives prior to Law 8. During the first ten months of 1998, however, 1,639 new enterprises were established in the main activities eligible for incentives. This represents an acceleration of nearly 580% over 1996. The largest relative increase, however, occurred in 1997, when Law 8 was in force only part of that year.

Table 2
Number of Companies Established with Investment Incentives

	1994	1995	1996	1997	1998
Industry	**47**	**91**	**117**	**622**	**1,137**
Agriculture/Construction	**3**	**5**	**14**	**80**	**179**
Tourism	**15**	**33**	**90**	**162**	**242**
Free Zones	**11**	**17**	**21**	**63**	**81**
Total	**76**	**146**	**242**	**927**	**1,639**

Source: GAFI, Information Center

The largest number of eligible new establishments were created in industry, which accounted for 62% of the total in 1994 and 70% in 1998. The slowest, but still substantial growth of new companies, 169% since 1996, occurred in the tourist sector, while the industrial sector achieved a tenfold increase.

A substantial acceleration in the establishment of new companies qualifying for tax holidays occurred in all eligible sectors under Law 8 compared to previous legislation, particularly in 1997 when the new law went into effect. This acceleration is highly significant not only for Egypt's incentive policies, but also for its investment policy in general. A significant surge in the establishment of new companies occurred not because the incentives offered by Law 8 are more generous than the incentives under previous legislation, but because administrative approval procedures were significantly relaxed, streamlined, and accelerated. Under Law 8, approval is automatic and rapid for eligible investments, whereas previously each investment underwent a lengthy, complex, discretionary approval process. This more cost efficient, more effective new approval process clearly produced a greater private sector response.

4.4 Cost Effectiveness of Law 8 on Free Zone Development

Establishment of new firms in the free zones had the slowest development under previous laws and continues to show the slowest development in absolute numbers. This is surprising in view of the fact that the most generous incentives are being offered to firms locating in the free zones. The Suez Canal places Egypt in as favorable a geographical location for free zone operations as Panama with its Panama Canal. The Panama Free Zone has evolved into the world's largest or second largest free zone, which thousands of companies use for convenient and cost effective inventories, assembly, rerouting, re-labeling, value added mixing, adding, and manufacturing. In recent years, Panama has attracted major private investments in transshipment port facilities near the Canal, thereby further enhancing the usefulness of its Free Zone for a multitude of companies organized for servicing nearby markets.

The following table demonstrates that Egypt's free zones are being used mainly for imports from Asia into the Egyptian market. By contrast, Panama's and other Latin American free zones are used almost exclusively to employ large numbers of low wage local labor in assembly and manufacturing of imported inputs for re-export to other countries. The main purpose of free zones in most developing countries is to import components for re-exporting finished products to foreign markets. Importing into the domestic market is discouraged by regulations or administratively.

In the case of Egypt, half of all inputs into the free zones arrive from Asian countries and most of the rest from Europe and the Western Hemisphere (less than 10% from Egypt). Nearly 77% of all shipments from the free zones go to Egypt and only 23% to foreign markets. Thus it can be concluded that Egypt's free zones are not traditional re-export operations benefiting from fiscal incentives and low cost labor, but importing operations for the domestic market benefiting from permanent fiscal incentives and low cost labor. Egypt's free zones are industrial parks with simple import operations rather than free trade zones.

Table 3
Egyptian Free Zone Exports and Imports
($ mill.)

	Exports		Imports	
	1997	**1996**	**1997**	**1996**
Asia/Australia	12	13	598	487
Europe	114	87	327	368
Western Hemisphere	94	61	186	102
Arab Countries	163	148	22	21
Africa	2	1	1	5
Total	385	310	1,134	983
Domestic Market	1,104	735	61	46
Among Free Zones	44	24	51	11
Free City	104	108	1	2
Other	10	5	2	3
Total	1,262	872	115	62
Grand Total	1,647	1,182	1,249	1,045

Source: GAFI, Information Center

Table 4
Capital Issued According to Origin of Companies Established in Free Zones
(LE mill.)

	First Ten Months	
	1998	**1997**
Egyptian	1,008	2,512
Arab	47	79
Other Foreign	129	64
Total	1,184	2,715
Egyptian as % of Total	85	92

Source: GAFI Information Center

Mostly Egyptian rather than foreign capital has been attracted by investment incentives to the free zones in Egypt, according to the statistics in the accompanying table from GAFI's Information Center. Egyptian companies accounted for more than 85% of the total issued capital of companies established during the first ten months of 1998 and 92% during the corresponding months in 1997. It can be concluded that it is largely Egyptian company investment that is attracted by generous incentives to the free zones for importing mostly from Asia to supply the domestic Egyptian market, rather than exporting to foreign markets. Although new capital issued by foreign, non-Arab companies doubled in 1998 compared to the previous year, it is still only a relatively small 10% of the total.

Given a choice, Egyptian companies can be expected to prefer to locate their investments in the free zones in order to enjoy permanent fiscal incentives while supplying the domestic market with imports rather than locating outside the free zones and paying corporate income tax on profits from importing. A preference for locating in the free zone exists when the tax benefits of a permanent tax holiday outweigh the 1% duty on the total value of the shipment out of the free zone. In either case, regular import duties apply when products are imported directly or via the free zones.

The GOE has recognized this opportunity for abuse due to the vagueness in the law and issued Decree 619 authorizing GAFI to start refusing licenses to establish import operations in the free zones. In practice this must already have been happening, because the data show a marked decrease in new capital formation by Egyptian companies in the free zones from a record LE 2.5 billion in the first ten months of 1997 to LE 1.0 billion in the corresponding period of 1998.

Thus Law 8 has allowed permanent tax holidays for Egyptian companies to set up mere importing operations in the free zones for supplying the domestic market. The cost to the GOE is a permanent loss of income tax revenue on the profits these companies generate from their import operations, less the 1% duty assessed on the total value exported. This result of the law is clearly not cost effective.

4.5 Impact of Law 8 on Investments

The planned capital issues by companies eligible for investment incentives expanded to LE 13.5 billion in 1997, compared to LE 4.3 billion in 1996. Large increases occurred in all four major sectors in 1997, as shown in the accompanying table. The growth of capital expansion slowed considerably in 1998, both relatively and absolutely. Agricultural and construction companies combined showed the most pronounced growth in capital expansion during 1997-98 versus previous years, while new capital formation contracted significantly in the free zones in 1998 after a notable increase in 1997. It can be concluded that planned capital issues in sectors eligible for tax holidays expanded substantially in 1997-98 when Law 8 started operating versus earlier years.

Table 5
Planned Capital Issues of Companies Eligible for Incentives
(in LE mill.)

	1994	1995	1996	1997	1998
Industry	**417**	**1,310**	**1,787**	**4,971**	**6,065**
Agriculture/Construction	**9**	**81**	**106**	**907**	**3,692**
Tourism	**216**	**760**	**2,121**	**4,858**	**4,488**
Free Zones	**1,258**	**92**	**331**	**2,746**	**1,184**
Total	**1,900**	**2,243**	**4,345**	**13,482**	**15,429**

Source: GAFI, Information Center

The average size of a tax-exempt company's issued capital investment was about LE 20 million prior to Law 8 and only LE 12 million in the last two years when Law 8 started operating, as indicated in the accompanying table. The tourism sector was mostly above the average, while the industrial sector was well below the average. The trend is toward smaller investments benefiting from incentives.

Table 6
Average Planned Capital Issue Per Company
(in LE mill.)

	1994	1995	1996	1997	1998
Industry	**8.8**	**14.4**	**15.3**	**8.0**	**5.3**
Agriculture/Construction	**3.0**	**16.2**	**7.6**	**11.3**	**20.6**
Tourism	**14.4**	**23.0**	**23.5**	**30.0**	**18.5**
Free Zones	**114.4**	**5.4**	**15.8**	**43.6**	**14.6**
Average Total	**25.0**	**15.4**	**18.0**	**14.5**	**9.4**

Source: GAFI, Information Center

Egypt's investment incentive law is benefiting primarily Egyptian companies. Only 7% of the issued capital originated in Arab countries in the first ten months of 1998 and 12% in other foreign countries, as shown in the accompanying table. Egyptian capital dominated all major sectors, but less so in the combined agriculture and construction sector. Total investment in this sector expanded considerably in 1998, probably in construction related to the building boom, particularly in new urban areas. Both non-Arab foreign and Egyptian capital showed a large increase from a small base.

Table 7
Planned Capital Issues by Origin and by Sector
(LE mill.)

	Egyptian	Arab	Other Foreign
Industry	**5,316**	**439**	**310**
Agriculture/Construction	**2,203**	**106**	**1,383**
Tourism	**3,966**	**469**	**53**
Free Zones	**1,008**	**47**	**129**
Total	**12,493**	**1,061**	**1,875**
% of Total	**81**	**7**	**12**

Source: GAFI, Information Center

4.6 Impact of Law 8 on Employment, Exports, Technology Transfer, and Revenues

Data are not available to estimate how much additional income and tax revenue have been generated by a multitude of supplier, contractor, and service companies that experienced additional business as a result of the investments undertaken by companies that were granted investment incentives. Statistics are not available to make comparisons about employment, exports, technology transfer, and tax revenue generated indirectly in this way by new investments promoted by fiscal incentives under Law 8 and previous legislation. Rough estimates offered by informed sources are not reliable and vary greatly -- from an order to 2 to 10. An order of 2, for example, would mean that twice as much employment is being created indirectly by diverse firms as a result of additional business generated by an investment receiving incentives than by the tax-exempt company itself. An order of 2 also would mean that the tax revenue generated from direct and indirect employment and business activity generated by a new investment receiving incentives is twice the tax revenue temporarily foregone due to the tax holiday.

The unavailability of data permitted only a very tenuous statistical approach using macro-economic data.

4.61 Impact on Employment

Job creation in the main sectors of the Egyptian economy benefiting from investment incentives accelerated somewhat faster in fiscal year 1997/98 when Law 8 was operating than in previous years under earlier legislation. As shown in the table below, an additional 292,000 jobs were created in these main sectors in fiscal 1997/98, versus 198,000 and 172,000 in the two prior fiscal years. The relative increase was 3.6% in fiscal 97/98 versus 2.55% in 96/97 and 2.2% in 95/96.

Table 8
Employment Creation in the Main Economic Sectors Eligible for Incentives
(Fiscal Year Increases in Employment)

	1995/96	**1996/97**	**1997/98**
Industry	**70,000**	**72,000**	**144,000**
Agriculture	**36,000**	**54,000**	**73,000**
Construction	**62,000**	**67,000**	**75,000**
Tourism	**4,000**	**5,000**	**0**
Total New Jobs	**172,000**	**198,000**	**292,000**

Source: Quarterly Economic Report, November 1998, Ministry of Economy

This acceleration in job creation was most pronounced in the broad sector of industry where all new investments are eligible for incentives. In industry 144,000 new jobs were created in fiscal 1997/98 versus only 72,000 in fiscal 96/97 and 70,000 in 95/96. The relative increase was 7.0% in 97/98, 3.7% in 96/97 and 4.0% in 95/96.

Faster job creation can be the result of any number and combination of factors, such as government fiscal and monetary policies, market opportunities, and financial flows. Combined, however, with the acceleration in capital formation in the sectors receiving investment incentives documented above, one can assume that tax holidays contributed to the acceleration of job creation in three of the above four sectors. It is impossible, however, to separate out the share of job creation attributable to the incentives offered under Law 8 versus earlier legislation. The newness of Law 8 and the lag time for investments and hiring would suggest that many jobs created in fiscal year 1997/98 may still have come from investments completed with incentives from previous legislation.

Total employment in the six public free zones (Alexandria, Port Said, Nasr City, Suez, Ismailia, and Damietta) and in the private free zones created and planned by companies receiving fiscal incentives expanded by 21,229 from mid-year 1996 until mid-year 1997, and by 16,586 from mid-1997 until the end of September 1998 when Law 8 was operating. Other statistics from GAFI show 22,000 jobs were created and planned under Law 8 from May 12, 1997 until September 30, 1998.

Statistics published by GAFI do not clarify how many permanent jobs were actually created by companies operating with incentives under Law 8 versus previous legislation. The following data from GAFI show the number of jobs the companies plan to create with their new investments.

Total Number of Jobs Planned by Companies Receiving Incentives

	First Ten Months of the Year 1997	1998
Industry	**44,441**	**65,235**
Agriculture/Construction	**6,843**	**29,090**
Tourism	**19,933**	**32,844**
Other	**3,395**	**6,272**
Free Zones	**7,321**	**17,741**
Total	**81,933**	**151,182**

Source: GAFI, Information Center

4.62 Impact on Export Development

As documented above, the generous investment incentives offered to companies locating in the free zones did not produce the intended objective of stimulating the growth of assembly industries for re-exporting out of the free zones to foreign markets. Exports from the free zones to foreign markets increased only 7% in fiscal 1997/98.

Exports outside the free zones by companies eligible for investment incentives are among those classified as non-traditional or unclassified. They exclude petroleum, cotton, cotton yarn, rice, and citrus fruits. Non-traditional and unclassified exports have grown significantly recently both relatively and as a share of total exports.

These exports grew 21% in fiscal year 1996/97 and 24% in fiscal 1997/98. Total exports actually decreased by nearly 5% during the latter period. The share of non-traditional and unclassified exports in total exports accelerated from 43% in fiscal 1995/96 and 45% in fiscal 1996/97 to 57% in fiscal 1997/98, the period Law 8 was in force. Although no statistics are available that separate exports by tax-exempt companies from non-tax exempt exports, the accelerating growth of non-traditional exports at the same time that total exports decreased suggests that Law 8 incentives might have had a spill-over effect in faster growth of non-traditional exports.

Table 9
Total, Non-Traditional and Unclassified Exports

	Fiscal 1995/96	1996/97	1997/98
Total Exports ($ mill.)	**4,609**	**5,345**	**5,128**
Non-Traditional & Unclassified	**1,960**	**2,381**	**2,941**
% Share of Total	**43**	**45**	**57**
% Growth from Prior Year		**21**	**24**

Source: Egyptian Center for Economic Studies

4.63 Impact on Technology Transfer

The GOE pursues policies of encouraging the transfer of new technologies from abroad. Importation of new technologies by foreign investors was considered a distinctly positive factor in the approval of incentives for new investments under legislation prior to Law 8, such as Law 43 of 1974. Applications were evaluated on the basis of the type of technology to be imported, worker training in the use of this technology, and equipment with new technologies to be imported. Under the automatic approval process of Law 8, technology transfers are left free to market forces.

4.64 Impact on Tax Revenues

There are no data available at this time to estimate even roughly the impact on tax revenues of tax holidays under Law 8 compared to previous legislation. Data would need to be collected for the following set of calculations:

- Net profits of companies that were granted tax holidays to estimate the revenue lost due to the tax holidays.
- Import duties not collected due to the tax exemption under Law 8.
- The total annual payroll of the jobs created by tax-exempt companies in order to calculate the additional personal income taxes paid by the work force employed due to the investment incentives.
- Creation of a matrix of all the other inputs generated by the investments enjoying the tax holidays, followed by a calculation of the taxes associated with the additional profits generated by the companies providing these inputs, together with the taxes associated with the additional employment created by these contractors, suppliers, producers, distributors,

bankers, and other service companies. Revenues from additional import duties will also accrue to the government from imports by these suppliers of inputs for the tax-exempt investments.

- In this way the net tax revenue gained or lost from the tax-exempt investments can be partly calculated. The calculation will be incomplete, because the multiplier effect continues beyond the first stage outlined above. Direct suppliers of inputs to the investment in turn generate increased demand for inputs in order to satisfy their additional requirements.
- To complete the calculation of the net revenue effect of tax holidays, it would be necessary to estimate the revenue lost from granting tax holidays to companies that would have made the investment whether or not they received the incentives.

An input-output matrix for the Egyptian economy was obtained from Dr. Maurice Thorne of Chemonics. It exists only for fiscal 1996-97, the period prior to the introduction of Law 8. It shows the domestic and imported input coefficients for 32 categories of the Egyptian economy. The categories include all the activities under Law 8, but are not subdivided according to the classification of Law 8. The matrix has limited applicability for a revenue gain and loss calculation. The data do not relate inputs or outputs to profits from which tax liability could be estimated. The matrix shows only the first stage of the multiplier effect, minus the payroll effect, with inputs restricted to production. The investment phase itself requires important inputs in terms of contractors, construction workers, extension of utilities, communication lines, access roads, legal services, etc.

It can be concluded that the net revenue effects of the tax holidays of Law 8 compared to earlier legislation cannot be calculated or reliably estimated without considerable further research. Time did not permit a sample calculation.

4.7 The Role of Investment Incentives in the Decision to Invest in Egypt

Some informed sources that deal with the private sector on a daily basis emphasize that decisions to invest in Egypt by private foreign and domestic investors are generally not motivated by fiscal incentives, except among some smaller local companies and free zone companies enjoying permanent tax holidays. In this study, the issue whether or not investments would have been made regardless of fiscal incentives is less relevant, because the central issue is to compare the cost effectiveness of the incentive program under Law 8 with that under previous legislation. Under both programs, investors have been offered very similar fiscal incentives. It can be assumed, therefore, that in both cases, the same companies would have reacted in the same way to the fiscal incentives.

Large multi-million dollar foreign investments have not been attracted by Law 8 or by previous investment incentive legislation. Yet it is large investments that have important multiplier effects for the economy by generating exports and foreign exchange earnings, stimulating job creation and worker training, income and tax revenue directly and indirectly among many ancillary local contractors, suppliers, importers, producers, and service providers.

Private investments are attracted to desert areas for reasons other than fiscal incentives, according to some informed sources. The best and newest infrastructure provided by the government at subsidized prices is considered a prime factor for the success of drawing private investments to these new areas. Improved infrastructure and subsidized rates for use of utilities are also incentives, although not fiscal incentives, that improve the bottom line for investors. Apparently, after a decision to invest has been made, then, of course, investors avail themselves also of the tax benefits under Law 8.

A tax holiday for five years after start-up of production is not considered sufficiently generous to weigh heavily into a decision to invest. Law 8, in contrast to earlier legislation, does not allow extension of the period of a company's tax holiday. It has been suggested that companies can circumvent this restriction by closing their subsidiaries after their tax holidays expire and then forming new subsidiaries to enjoy additional tax holidays. Law 8 does not permit a company to merge its profits from an investment qualifying for a tax holiday with profits from other operations. Instead, a separate company has to be formed for an investment to receive tax holiday status in order to avoid as much as possible shifting profits from taxable to tax exempt investments.

Some companies operating with narrow margins in highly competitive consumer product sectors have indicated that tax incentives offered by the GOE were key to their decision to invest in Egypt. The tax holidays made the start-up of their new investments viable.

Some informed sources indicated that fiscal incentives were essential to offset the cost effects associated with

- High import duties ranging from 30% to 50% ad valorem on inputs for the production process;
- Arbitrary, inflated reference prices established by Customs to offset under-invoicing of imports by some, but not all importers;
- Time-consuming procedures and long delays in obtaining duty drawbacks on imported inputs for final products destined for exporting;
- Costly bureaucratic delays in moving cargo through customs and ports;
- Foreign-owned companies, such as Procter & Gamble, even though incorporated under Egyptian laws, not being allowed to import, except through Egyptian nationals; and
- Other impediments to efficient production and distribution caused by inadequate infrastructure and government administrators.

Some companies have to employ specialized private agencies to expedite movement of cargo through Egyptian ports and to deal with Customs. Some pay excessive import duties above the official rate, because Customs establishes artificially high reference prices to counter balance under-invoicing of low-cost imported inputs for production. Rectifying such misguided decisions by Customs can be a very protracted, costly process. Low import duties would reduce the practice of under-invoicing by some importers.

The above inefficiencies can significantly inflate the costs of doing business and thus artificially enhance the importance and permanence of investment incentives for the viability of an enterprise in Egypt. Reducing or removing the above inefficiencies for affected companies would lower the cost effectiveness of investment incentives.

A number of countries in Latin America have reduced or eliminated the above types of impediments, as well as the granting of fiscal incentives. Chile, for example, has established a uniform, low 9% import duty on all imports, without exceptions, and thus essentially has eliminated the problem of under-invoicing, arbitrariness and corruption at Customs. Chile and other countries have been able to eliminate their fiscal incentive programs replacing them with government guarantees, including, in some cases, long-term corporate tax rate stability as part of long-term contracts with individual foreign firms making large investments.

Law 8 offers complete tax holidays to new investments in a variety of specified activities that the Government wants to encourage. Most are narrowly defined activities. There are also some very broad and all-inclusive categories, such as industrial activities and manufactured products. Industry can include a steel mill, truck manufacturing, oil refineries, and a chemical complex, as well as manufacturing of buttons, toothpicks, brushes, nails, and candy. The largest private investment project will obviously have the largest multiplier effects throughout the economy, while the smallest investment will have the smallest effects. Law 8 offers all of them the same fiscal incentives regardless of the benefits produced for the economy in terms of employment, exports, value added, technology, tax revenue, economic development, or ancillary activities. Earlier legislation offered fiscal incentives to similar broad categories. Thus there is no significant improvement in the cost effectiveness in this respect under Law 8 compared to earlier legislation.

Under the current set-up a small investment with large profits receives a greater benefit from the tax holiday than a large investment with small profits. Investment tax credits and accelerated depreciation allowances offer larger absolute tax benefits to large investments than to small investments. In this sense, investment tax credits and accelerated depreciation allowances can be considered more cost effective than the tax holidays offered by Law 8 and previous legislation.

Both Law 8 and previous incentive legislation offer tax holidays rather than other forms of investment incentives for eligible investments in activities the GOE wishes to promote. Tax holidays open the door for existing companies to place eligible investments in new subsidiaries, to shift taxable profits to the exempt subsidiaries, and to shift tax-deductible costs from the tax-exempt subsidiaries to the taxed parent companies. This is a circumvention of the provisions and the spirit of incentive legislation. Other forms of investment incentives, such as tax credits, could prevent these avoidable tax revenue losses better and be more cost effective.

5.0 Conclusion

The cost effectiveness of tax holidays under Law 8 compared to previous legislation has been assessed in this study. Relatively complete information about applicable legislation permitted comparisons between Law 8 and previous laws. The changes in the administration of investment legislation were also studied. GAFI was the main source of the available statistical data relevant for this study. Not all the data necessary for cost effectiveness calculations could be obtained, and the data show planned rather than actual investment and employment.

Sufficient insight was gained, however, to conclude that there has been a clear improvement in cost effectiveness of the investment incentives offered under Law 8 versus previous legislation. Qualitative improvements have been identified under Law 8 versus previous legislation, particularly a more efficient, automatic, speeded-up approval process. A statistical analysis revealed positive results in terms of more companies and investments, more jobs and more exports generated and/or planned under Law 8 than for a comparable period under previous legislation. The period since Law 8 started operating is too short, however, to draw conclusive judgments in areas where results depend on the completion of investments and the start of production. Data were not available to assess the net impact on government revenue.

Relatively less favorable results under Law 8 can be recorded in two areas:

- Relatively little foreign investment has been attracted by investment incentives and its share in the total has declined somewhat under Law 8.
- The generous incentives available to investments in the Free Zones have not led to dynamic export development. Instead, permanent tax exemption has encouraged the growth of simple import operations from the free zones into Egypt. The GOE is now aware of this problem and has issued a new decree to arrest further development of this practice.

Investment tax credits and accelerated depreciation and other tax incentives that reward investments rather than profitability are generally more cost effective forms of investment incentives than tax holidays. These alternative forms offer governments some tax revenue in the first year of profitable operation and the revenue collected is related to profitability.

Many countries employ investment incentives as strategies closely tied to national economic objectives, such as investment incentives reserved for companies that develop non-traditional exports or the infrastructure sectors of the economy or large employment or remote areas of the country. Egypt seems to have followed this targeted approach only partly. Offering a tax holiday indiscriminately to all companies large and small in all industries is probably not cost effective unless such generosity is required to offset other serious impediments to private investment.

Egypt has removed some important impediments to investment by the private sector. Egypt has facilitated procedures for new investments and establishing enterprises, including improvements made by GAFI and the functioning of "One-Stop Shops" for investors. Further progress in eliminating impediments that raise the costs of doing business would permanently benefit the economy and would lower the cost effectiveness of tax holidays. By greatly liberalizing investment controls and procedures, most Latin American countries have been able to replace investment incentives with government guarantees concomitantly with reforms designed to establish open, market driven economies. Recently the Wall Street Journal and the Heritage Foundation published their annual index of economic freedom, widely read by US investors. On a scale of 1 to 160, it shows Egypt at 97, compared to Morocco and Tunisia at 65 each, Greece at 62, Turkey at 54, Peru at 41, El Salvador at 22, and Chile at 18.

Appendix A: Consultants' Work Experience

Siegfried Marks is a senior international economist and consultant with many years of work experience with the public and private sector on a wide range of projects in the Middle East, Latin America, Caribbean, Philippines, and the countries of the former Soviet Union. He has done projects for USAID, the World Bank, the UN Development Program, the Inter-American Development Bank, the Economic Commission for Latin America and the Caribbean, for governments, major oil companies and other private companies, and universities. His experience relates to trade and investment promotion, free trade agreements, investment incentive legislation, legal and regulatory reform, privatization, petroleum market analysis, evaluation of public institutions and private sector organizations. He developed detailed proposals for privatizing and reforming Egypt's port services and a comparative analysis of impediments to private investments in Egypt, Turkey, Israel, Morocco, and Tunisia.
Dr. Marks is President of the Miami-based consulting firm, Sigmar International. Earlier he was the Chief Economist and Political Advisor for Latin America and the Caribbean with Exxon (Esso) Corporation in charge of all political, economic, and oil policy analyses for the company's regional operations.

Pierre Gianni, Licencié en Droit, Diplomé d'Etudes Supérieures de Droit Privé, Diplomé de l'Institut d' Etudes Politiques, LL.M. U.S. Taxation, is an international lawyer specialized in corporate law and taxation. Mr. Gianni has over 20 years work experience with major law firms, and international corporations in France, Europe, Africa and the U.S. In prior positions, Mr. Gianni was a Director with both Coopers & Lybrand and Ernst & Young and a consultant with KPMG-PeatMarwick. Mr. Gianni has extensive experience in consulting assignments in developing countries and is the author of a 1995 study for USAID on corporate and capital market laws in Egypt.

Appendix B: List of Interviewed Contacts

Babaa El-Bakly, Head of Free Zones Sector, General Authority for Investment, Cairo

Dr. Ibrahim Fawzy, President, General Authority for Investment and Free Zones, Cairo

Dr. Heba Handoussa, Managing Director, Economic Research Forum, Cairo

Hassan M. Hussein, Chief Executive, The International Investment Advisor, Cairo

Frederick Jaspersen, Senior Economist, International Finance Corporation, Washington

Taha M. Khaled, Managing Partner, Zarrouk, Khaled & Co., Public Accountants and Tax Advisors, Cairo

James L. Kenworthy, DEPRA Project, Nathan Associates Inc., Cairo

Heba Malawani, Under-Secretary in Charge of the Technical Office, GAFI

Dr. Mauro Mecagni, Resident Representative, International Monetary Fund, Cairo

Dr. Mahmoud Mohieldin, Senior Economic Advisor to the Minister of Economy, Government of Egypt, Cairo

Wayne Neill, Counselor for Political and Economic Affairs, U.S. Embassy, Cairo

Dr. Ahmed Shawki, Managing Partner, Deloitte Touche Tohmatsu International, Cairo

Dr. Sohier S. El-Sherif, TAPR Project, Chemonics International Inc., Cairo

Vito Tanzi, International Monetary Fund, Washington

Peter F. Smit, Vice President and General Manager, Egypt & East Africa, Procter & Gamble, Cairo

Brian Smith, Commercial Attache, U.S. Embassy, Cairo

Dr. Maurice Thorne, DEPRA Project, Chemonics International Inc., Cairo

Dr. Sahar Tohamy, Senior Economist, Egyptian Center for Economic Studies, Cairo

Dr. Peter Wogart, Senior Economist, International Finance Corporation, Washington

Howell Zee, International Monetary Fund, Washington

Appendix C: List of Documents Reviewed

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Appendix D: Terms of Reference of the Project

Concept Paper

MONITORING PROGRESS UNDER SPR AND ASSISTING THE GOE IN ACHIEVING THE SPR POLICY MEASURE TO MAKE INVESTMENT INCENTIVES MORE COST EFFECTIVE

1. Objective

The overall objective of this proposed activity is to improve the cost-effectiveness of investment incentives and thereby assist the Government of Egypt (GOE) in its transition to a market economy. More specifically, this activity will: ascertain whether the GOE has implemented the policy reform measure agreed to under SPR II to make investment incentives more cost effective; and, if the GOE has not implemented the measure, to make recommendations as to how it might do so. In order to achieve this objective, this activity will mobilize two consultants to analyze the policy reform in question and to offer technical assistance if necessary.

2. Background

In 1992, USAID signed an agreement with the GOE to implement a Sector Policy Reform Program (SPR). SPR I was a two-year, $400 million grant program that disbursed cash to the GOE for enacting policy reforms. Since SPR I, the GOE and USAID have signed two follow-on agreements, SPR II and SPR III, which follow the same general approach as SPR I. Both SPR I and SPR II have contained measures addressing investment incentives.

Legislation governing investment incentives has evolved over the years. In 1981, Corporate Law 159 established the procedures for setting up financial enterprises. This law canceled Laws 26, 244, and 137 from the years 1954, 1960, and 1961, respectively. In 1989, Investment Law 230 made allowance for Arab foreign investment and free zones, permitted foreign management of enterprises in Egypt, and instituted procedures for tax holidays. Law 230 replaced Laws 32 and 43 from the years 1977 and 1974, respectively. In the beginning of the 1990s, Public Enterprise Law 203 was issued to overcome obstacles to the privatization process. Incentive Law 8 was issued in 1997 to encourage different kinds of investment and incentives to enhance them.

3. Scope of Work

The text in SPR II reads, "the GOE will make its investment incentives more cost effective". Under this activity, the consultants will ascertain whether recent changes in investment incentives are more cost effective. Specifically, they will perform the following tasks:

1. Legislation

X Compare existing laws, clarifying what legislation governs what, including what changes have taken place in recent years.

X Assess the degree to which procedures for establishing businesses have been streamlined.

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2. Practical Considerations

X Assess the dispersion of new enterprises in different sectors.

X Assess whether legislative changes have facilitated the establishment and operation of enterprises in terms of capital invested, number of enterprises, etc. (quantitative estimates are preferred, though not absolutely essential).

3. Related Legislation Affecting Investment Incentives

X To the extent possible, take into account the effect of other legislation on investment, for example, labor laws, social security, tax administration, capital markets.

4. Recommendations

X To the degree that the consultants find existing incentives deficient, make recommendations for improving them.

4. Qualifications

The consultant team will consist of two experts. One of the team members will be a macro economist and the other a tax specialist. The two experts will be familiar with USAID and GOE policy programs and procedures for their implementation. Their expertise will reflect a familiarity with issues central to Egyptian economic policy reform.

5. **Reporting**

The two consultants will report as a team directly to the TAPR chief of party or his designee.

At the end of the first two weeks of the activity, the consultants will prepare a detailed outline of their preliminary findings and present them verbally to the Sector Policy Division of USAID. At the end of the activity, the consultants will submit a report presenting their findings and recommendations.

The team will submit the report in five(5) copies. The final report will be conveyed in computer diskette form in WordPerfect 5.1/5.2.

6. **Level of Effort**

Each of the two consultants will work for a period of one month.