PRIVATIZATION IMPLEMENTATION PROJECT

The Costs of Not Privatizing: An Assessment for Egypt

SURVEY AND EMPIRICAL ANALYSIS

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IBM Consulting / Global Economic Development

Summary of Study

March, 2004

Submitted to:

United States Agency for International Development / Cairo, Egypt Mission

Support for Economic Growth and Institutional Reform /
General Business, Trade, and Investment
Contract No. PCE-I-00-98-00017-00, Task Order No. 845

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Acknowledgements

This study owes its fundamental acknowledgement to Tony Chan, Ph.D., USAID/Cairo's Supervisory Program Economist, who provided its broad vision from the outset. He wanted a report, founded on a strong empirical base, which would elucidate the extensive interconnections between privatization and overall macroeconomic performance in Egypt. This overarching vision drove our work and made the project a highly stimulating challenge in applied economics. We also thank Remah Talaat, Project Manager at USAID/Cairo.

This report would not have been possible without the untiring support of the USAID Privatization Implementation Project for Egypt, managed by IBM Business Consulting's Economic Development Practice. In particular we thank Richard Moss, the project's Chief of Party, who provided oversight and editorial input throughout; Fouad Abdel Wahab, Senior Advisor, who made critical technical contributions; Dr. Imam Lotfalla, who provided valuable technical assistance and senior advice; Nevine Lotfi, Investment Banking Advisor, who led the research support effort; Ayman Taha, Investment Banking Advisor, who conducted banking research; Emad Moursy, Investment Banking Advisor, who conducted insurance and Law 203 holding company research; and Mohamed Ragui, who provided senior technical advice throughout the preparation of the Study. Numerous other members of the PIP staff assisted us in many ways and we deeply appreciate their enthusiastic support. This truly was a joint effort by a great project team.

We wish to thank the many professionals and thought leaders from the Egyptian government, institutional, and private business sectors who gave us their time in our background investigations for this report. We would mention in particular Dr. Faika El Rafaie, Member of Parliament; Hamdy Rashad, former Director of the Public Enterprise Office; Mohamed Hassouna of the Public Enterprise Office; Dr. Sahar Tohamy, Assistance for Trade Reform Project; Dr. Sahar Nasr, World Bank/Cairo Senior Economist; David Osgood of the WWSPR Water Project; Magda Assaad, among others.

Finally, we must acknowledge the many researchers in the area of privatization whose work has preceded ours. We appreciate advice from John Nellis of the Center for Global Development in Washington and Ahmad Galal of the Egyptian Center for Economic Studies in Cairo. We are indebted to the many authors whose outstanding work we researched – the inherited intellectual foundation upon which this report is built.

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1. Conceptual Foundation

1.1 Motivation for the Study

The purpose of this study is to evaluate, by various means, the costs of not privatizing in Egypt. By characterizing the project in this way, we make a value judgment at the outset: that Egyptian privatization has been too slow. In the extensive economic literature that exists on privatization, the focus is on the costs of doing too little of it, but in the political arena, the preoccupation is usually on the costs of doing too much. Our study is directed at Egyptian policymakers, and its aim is to reduce the political resistance to aggressive privatization – to balance the privatization debate in Egypt with an assessment of the costs of inaction.

"Not privatizing" does not mean the complete absence of privatization. It is shorthand for gradualistic, deliberative, painstaking privatization, as opposed to ambitious, rapid privatization. There are very few developing country governments left whose economic growth policies do not incorporate privatization of state-owned businesses, in many cases all the way through to major utilities such as water and electricity.

In fact, the Government of Egypt (GOE) forcefully committed itself to privatization more than a decade ago as a pillar of its economic renewal policy. The broad purpose of the 1991 Economic Reform and Structural Adjustment Program was the acceleration of a trend

Major Report Findings

- We estimate that the direct budgetary cost over the next five years of not privatizing Egypt's state-owned industrial companies, banks and insurance companies, and utilities is at least LE 100 billion ($18 billion) in present value terms. This is a huge burden – much more than the budget can afford to bear and still address social needs. Aggregating over this period, it represents one-half of the budget deficit, 4.3% of GDP, and 20% of total domestic savings.
- At the macroeconomic level, not privatizing has worsened Egypt's budget deficit, diminished foreign investment, aggravated the depreciation of the pound, restricted business finance, and retarded private sector employment expansion. Using counterfactual simulation, comparing Egypt's macroeconomic performance to that of aggressively reforming countries, we estimate that slow privatization has cost the Egyptian economy as much as 2 percentage points in real growth *per year* over the past decade. In employment, we estimate the cost at up to 1.0 million jobs – resulting in an unemployment rate of some 10% instead of as low as 5%. We estimate that the foreign investment inflow was half of what it could have been – about $10 billion instead of over $20 billion.
- Looking strictly at Egyptian data, we contrast the country's macroeconomic performance between the period of active privatization in the late 90s and the much slower privatization of recent years. We project that with an aggressive privatization program, bringing in an average of LE 5 billion in privatization proceeds per year over the next five years (versus just LE 0.4 billon on average over the last three), Egypt could expect LE 6 billion in annual FDI (versus LE 2.8 billion), gross fixed investment growth of 18% per annum (versus 2%), and over 600,000 new jobs per year (versus 270,000).

that had begun around 1970, at the close of the era of nationalization: the "opening up" of the Egyptian economy to market forces. The 1991 policy for the first time formally recognized the private sector as the key agent to lead economic growth. Enabling law, regulation, and institutions were established, including the Public Enterprise Office (PEO), and privatization finally took off in 1996. Some 200 industrial transactions were completed by 2000.

However, privatization in Egypt has since slowed to a crawl. Some 174 industrial companies producing commercial goods remain in state hands. This includes, for example, many hotels and most of the spinning and weaving companies – sectors for which is it very difficult to make an economic or welfare case for state ownership. All of the major utilities, including the national airline, are still in state hands, despite repeated commitments to initiate their privatization. The country's four largest banks, representing over 50% of total banking sector deposits and assets, and the dominant insurance company, publicly-owned at the beginning of the privatization process, are all still publicly-owned, despite a presidential decree in 1996 for their divestiture and a formal agreement with the IMF dating from that time to privatize at least one of them. The GOE retains significant majority and minority ownership in some 500 "joint venture companies" spread across the economy. Combined, the GOE is still involved in direct economic management of at least one-third of the Egyptian economy.

Total privatization proceeds to the GOE at end-2000 were some LE 15.5 billion ($4.0 billion), an average of about LE 3 billion per year over the five previous, active years from 1996-2000. But since then, in 2001-2003 *combined*, privatization earnings were little more than LE 1 billion. In the entire 2003 calendar year, the GOE privatized just four assets, for total proceeds of just LE 100 million. This dramatic slowdown in privatization progress in recent years is the basic motivation for our study.

Our study is empirical. First, we spend significant effort on a review of the empirical literature on the effects of privatization – a body of work that now includes dozens of studies covering hundreds of companies and almost every developing economy. The clear empirical conclusions of this literature should be part of the knowledge base of Egyptians in developing their own privatization policy. Second, we undertake a variety of new empirical investigations for Egypt, using data for the state-owned "Law 203" industrial companies, the banks and insurance companies, and the economic authorities and public utilities. Evaluating macroeconomic costs, we compare Egypt's performance with that of other important developing and transition economies, and investigate the macroeconomic impact in Egypt's own recent history of moving from more active to much slower privatization.

1.2 "Privatizing" and "Not Privatizing"

This report looks at privatization as a two-sided debate about implementation policy: "not privatizing" means gradualistic privatization, and "privatizing" means aggressive privatization. The following table sets out the key characteristics of these two approaches to privatization:

Table 1: **Characteristics of Alternative Privatization Policies**

"Not Privatizing" *(gradualistic privatization)*	"Privatizing" *(aggressive privatization)*
1. Overall Approach	
• Gradualistic approach guided by foundation philosophy that privatizing companies should be given the time to restructure under state ownership. Concern that privatization as an end in itself can leave companies in the hands of unqualified owners. Sensitivity to popular fear that privatization is unfair to workers and the poor, while benefiting the rich and powerful.	• Aggressive approach guided by foundation philosophy that almost any form of private ownership is preferable to state ownership. Attitude that political unpopularity and the short term costs of privatization must be suffered in order to realize the benefits. Core belief that privatization has a strong positive impact, beyond direct microeconomic effects, on macroeconomic competitiveness and growth.
2. Divestiture Pricing	
• Substantial effort devoted to target valuation of privatizing companies; resistance to flexible pricing. Government budget pressure to obtain high sale prices, and sensitivity to public perception of selling at too-low price. Tender procedures with unrevealed reserve price.	• Economic, flexible pricing criteria oriented toward market value to the buyer, with reserve price, if any, published prior to auction.
3. Privatization Governance Structure	
• Diffused privatization decision-making structure, with overlapping authority at higher-level boards, government ministers or ministerial councils, parliament, and with labor, management, and governing boards of the PEs themselves.	• Privatization transactions authority focused on the privatization agency with clear sales mandate, which has no role in the corporate governance of PEs. Higher bodies set policy only.
4. Employment Policy	
• Protection of employment levels / prevention of layoffs built into tenders.	• Buyers have considerable ability to right-size staffing upon privatization.
5. Financial Restructuring	
• Privatized companies remain obligated to repay past loans from state-owned banks, and arrearages to state-owned utilities and tax authorities.	• Companies are sold clear of accumulated excessive debt to state-owned banks and arrears to state-owned utilities and tax authorities.

The Government of Egypt, while affirming commitment to privatization, describes its approach as gradualistic:

> "Egypt's strategy of gradualism was designed to ensure political acceptability, social protection for its people and workers, and limited economic risk for investors . . . Egypt's privatization program has adhered to rational, well-studied steps . . . despite the international community's constant pressures to privatize with speed and vigor." (Ministry for Economy and Foreign Trade, 2001)

We recognize that a study of the costs of not privatizing should be more nuanced today than it perhaps needed to be ten years ago. A great deal of privatization has been done in the developing world over the past decade, and the record shows both positive and negative experiences. Not privatizing has costs, but so does privatizing. In our study, we describe and weigh both sides of the argument, first looking closely at the existing empirical literature, then evaluating Egypt's performance.

1.3 Review of the Empirical Literature on Privatization

Over the last five years many studies of the effect of privatization on company and macroeconomic performance have appeared. These studies are now so extensive – over 100 empirical studies, covering over 60 developing and transition economies and thousands of companies – that their findings can be considered conclusive. We review this literature in detail in the body of the report. The box below summarizes, in terms of five major components of sustainable economic growth, the findings of the empirical literature.

Findings of the Empirical Literature

- **Employment and wages:** Both leading up to and after the event, privatization usually creates immediate job losses in the privatized firms, in some cases substantial, because they are typically overstaffed under state ownership. However, empirical studies of the effect of privatization on economy-wide employment have *not* generally shown broader negative results. Some studies have shown that even the direct short-term negative impact in the privatized firms is reversed within a few years as they become competitive and grow. It has also shown that aggressive privatization is associated with rapid employment expansion in the private SME sector.
- **Government budget:** The favorable budgetary impact of eliminating operating subsidies to state-owned companies, increased taxes from more profitable privatized firms, and privatization proceeds themselves, more than offsets the costs of assistance to dismissed workers, the cost of state absorption of excessive debt of privatized companies, and lost dividends from those public enterprises that were profitable.
- **Foreign investment and business finance:** Countries that have pursued aggressive privatization policies have attracted significantly more foreign investment than have gradualistic privatizers, and, especially where financial sector privatization has also been aggressive, have generated and retained more domestic savings.
- **Competitiveness:** Privatized firms almost always perform better than state-owned firms in terms of revenue growth, profitability, quality of goods provided, and pricing. They are more competitive than public enterprises and offer consumers better choices and services.
- **Social welfare:** Average income in aggressively privatizing countries has in general risen and poverty has fallen. However, income distribution has in general worsened – a long-established trend in rapid economic development. All boats rise, but those of the rich rise more than those of the poor.

In three of the five components of sustainable economic growth – fiscal sustainability, foreign investment / business finance, and competitiveness – the empirical literature demonstrates that the costs of not privatizing are substantial. In perhaps the most sensitive issue in privatization, employment, the empirical literature demonstrates that the employment protection motivations of gradualistic privatizers lack substance – they are probably no better off than the aggressive privatizers. The only area with a partially negative result is in social welfare – privatization tends to increase income inequality. However, this result is critically offset by the finding that aggressive privatizers have higher average income levels overall than to do gradualistic privatizers. Citizens in the slow privatizing countries may be more

equal, but they are poorer – a description that fits many years of experience, in many countries, under statist forms of economic management.

The finding that privatized companies have better operating performance than state-owned companies is entirely consistent with economic theory and, with all the empirical evidence we now have, should now be accepted as fact.

2. Microeconomic Analysis – the Budgetary Costs of Not Privatizing

The goal of our microeconomic analysis is to estimate the direct cost to Egypt's fiscal budget of not privatizing its state-owned companies, in three categories: certain commercial production companies known as "Law 203" public enterprises,[1] the banks and insurance companies, and the utilities and economic authorities. We now summarize the results of our analyses of each of these three company groups.

2.1 The Law 203 Companies

Egypt's "Law 203" firms are owned by nine government holding companies. Their total sales were LE 32 billion in fiscal year 2001/02 (about 8.5% of GDP) and they had net operating losses of LE 850 million. Their external debts (not including loans from their holding companies) were LE 27.5 billion on June 30, 2002, and the holding companies owed an additional LE 4.5 billion of debt.

In our study we estimate the budgetary costs of not privatizing these companies. We use a financial markets valuation model, which estimates present values of two alternative cash flow streams to the GOE: (i) the expected cash flow that it would receive if it privatized the companies (which consists of privatization proceeds, net of privatization concessions, plus taxes received from privatized companies) and (ii) the cash flow stream that it can expect if it retains ownership of the companies (which consists of dividends less subsidies plus tax receipts from the state-owned companies). The difference between these cash flows is the cost of not privatizing these companies. If the present value of the cash flow of privatizing exceeds the present value of the cash flow of holding them, then the cost of not privatizing is positive.

We apply this approach to the complete database of 174 Law 203 companies still remaining in state hands. We conclude that:

- The cost of not privatizing the Public Enterprises – that is, the cost of inaction – is about LE 28 billion in present value terms. This is the direct potential budgetary benefit to the Government of Egypt, and is comprised of the following:

Net burden of ongoing operations to the GOE	LE	4.1 billion
Net burden of holding company operations		8.0 billion
Estimated privatization proceeds		21.0 billion
Debt and labor concessions by GOE[2]		- 9.2 billion
Incremental taxes received by GOE		3.8 billion
Total Cost of Not Privatizing Law 203 Companies	**LE**	**27.7 billion**

[1] Referred to in this way in Egypt because they were corporatized and organized under sectoral holding companies responsible for privatizing them by Parliament's Law 203 of 1991. There are numerous other state-owned commercial production companies not included in this group, such as, for example, companies owned by and providing materiel for the Ministry of Defense.

[2] Concessions are necessary to sell many loss-making companies.

- Most of the firms are badly in need of new capital investment, almost all of which will be forthcoming only from private investors. Indeed, such investment is essential for achieving industry profitability standards and revenue growth. It is estimated that, in addition to the LE 28 billion benefit to the GOE, the economy will gain an additional 8.5 billion of new capital invested in the firms by their new owners over a five- to seven-year period following privatization.
- Privatization opens the door to much-needed foreign investment so that Egypt is not forced to rely upon its own limited resources. Of the LE 16.7 billion of privatization proceeds in Egypt to date, 40%, or about $2 billion, was foreign direct investment (FDI). Furthermore, an estimated additional LE 4 billion in post-privatization investment has flowed into privatized companies to date. Combined, these investments represent two-fifths of total FDI in Egypt over the past decade.

2.2 The Banks and Insurance Companies

State-owned banks and other nonbank financial institutions, including insurance companies, thoroughly dominate Egypt's financial sector, providing almost two-thirds of total domestic finance. The four public sector banks represent about 58% of the commercial banking market in Egypt. At June 30, 2002, their total assets were LE 240 billion, and their net income after tax was LE 625 million, for a return on assets of only 0.28% – one-third the profitability of Egypt's private commercial banks. They hold almost 90% of the external debt of the Law 203 companies – about LE 24 billion – and if we conservatively assume that half of this cannot be serviced, then such loans would consume almost all of the current provisions of the four banks.

There are 14 insurance companies in Egypt, four of which are state owned: three general insurers and Egyptian Re-Insurance. These four state-owned insurers hold 87% of total industry assets of LE 15.4 billion (at June 30, 2002) and 80% of total life and non-life premiums. Industry assets are less than 4% of the assets of the banking industry. The most notable feature of the Egyptian insurance industry is its underdevelopment. The penetration of insurance products in the Egyptian market is quite low, with premiums representing only 1.1% of GDP. The average in other developing countries is 4 - 5%, and worldwide the figure is about 8%. Yet insurance companies would be an important source of medium and long-term financing, including equity, mortgage financing, and other long-term debt if the industry were better developed in Egypt. Our analysis of the insurance companies leads us to the following conclusions:

We applied our market valuation approach to the banks and insurance companies to derive their estimated budgetary cost of not privatizing, assembling statistics from the state-owned banks' annual reports and the Central Bank of Egypt. The following are our key conclusions, first with respect to the public sector banks.

- The basic budgetary cost of not privatizing the four public sector banks – the cost of the status quo – is no less than LE 16 billion in present value terms. This assumes that LE 14 billion in additional loan loss provisions – about double their current level – is needed to reflect the present value of the loan portfolio.[3] The cost of not privatizing is comprised of the following:

Estimated privatization proceeds	LE	5.2 billion

[3] To the extent that the banks' have received implicit or explicit assurances that the GOE will limit their losses on parts of their portfolio (e.g. loans to Public Enterprises), the banks may feel justified in not provisioning such loans, even if there is little hope of repayment from cash flows of the borrowers. Nevertheless, from the perspective of the GOE as shareholder, such loans represent a diminution in the value of the banks whether or not they are explicitly provisioned.

Net burden of ongoing operations to the GOE		4.8 billion
Incremental taxes received by GOE		5.9 billion
Total Cost of Not Privatizing Public Banks	**LE**	**15.9 billion**

- For the purpose of comparison, following are the results of a sensitivity analysis that assumes that the current level of provisioning of the four banks is adequate and that after privatization the banks could attain a 1.3% return on assets:

Estimated privatization proceeds	LE	16.7 billion
Less, net value of ongoing operations to the GOE		- 9.3 billion
Incremental taxes received by GOE		4.0 billion
Total Cost of Not Privatizing Public Banks	**LE**	**11.4 billion**

- The budgetary cost of not privatizing the four state-owned insurance companies – the cost of the status quo – is on the order of 3.0 billion in present value terms. In addition, up to 2.6 billion of post-privatization investment could be expected. The cost of not privatizing is comprised of the following:

Net value of ongoing operations to the GOE		-3.5 billion[4]
Estimated privatization proceeds	LE	5.8 billion
Incremental taxes received by GOE		0.7 billion
Total Cost of Not Privatizing Insurance Companies	**LE**	**3.0 billion**

- Total additional new capital required by the public sector banks, Including needs for increased provisions, is estimated to be on the order of LE 20 billion. With annual profitability of the four banks totaling less than LE 1 billion, it is wishful thinking to believe that the banks can grow out of the problem of insufficient capital. It is unlikely that the vast majority of the new capital requirements can be met other than through privatization.
- The GOE is currently investing in pre-privatization operational restructuring of these banks and insurance companies. This investment will probably not be recovered when the banks are eventually sold, because strategic buyers will want to implement their own systems and procedures.
- Ownership matters. The GOE is also engaging experienced banking executives from the private sector, which can lead to significant improvement in operations. But "privatizing management" does nothing to change the legal framework, to impose commercial incentives and eliminate political pressures, to increase capital, and to impose hard, market dictated economic constraints. Just as the Law 203 companies, which are barred from direct subsidies, can rely upon loans from the public sector banks to cover their cash flow deficits, state-owned banks in Egypt do rely upon their compliant government shareholder to tolerate liberal accounting practices and to replenish capital. Private shareholders, not having resort to powers of taxation or monetary inflation, are not so forgiving.
- New foreign firms entering Egypt in the financial sector will provide increasing competition to the less efficient and technologically capable state-owned firms, suggesting that the latter will lose value with the passage of time.

[4] A negative cost – i.e., the insurance companies do produce positive cash flow to the GOE.

2.3 The Economic Authorities

For our study we assembled information on 60 of Egypt's 61 major economic authorities. We focus our analysis on those that are potentially commercial, and on the major state-owned utilities – electricity generation, telecommunications, and water. Our major conclusions are:

- Inclusive of subsidies, the cost to the GOE of its potentially commercial economic authorities, leaving out the Suez Canal and the petroleum company, is budgeted to be LE 5.0 billion for fiscal 2003-2004. This reflects both social policy and poor operating economics. The present value cost of not privatizing these EAs, based only on their operating burden to the state, is in the neighborhood of LE 50 billion.
- The estimated total capital need over the next two decades for the three utilities on which we focus probably exceeds LE 200 billion. GOE financing of these needs appears impossible. Privatization is the only feasible means of raising the needed investment capital, and would have ancillary benefits in promoting the development long-term investment instruments for pension funds, insurance companies, and other institutional investors.

2.4 Summary Microeconomic Costs of Not Privatizing

The following table summarizes the findings of the preceding sections.

Table 2: **Summary Budgetary Costs of Not Privatizing**
LE billions, 2004-08

	Law 203 Companies	**Banks & Ins. Cos.**	**Economic Authorities**	**TOTAL**		
				LE	% Budg Deficit	% of GDP
Operating Burden	12.1	1.3	59.5	72.9	33.9%	3.1%
Privatization Proceeds	21.0	11.0	a	22.8	10.6%	1.0%
Less concessions	*-9.2*	0.0				
Tax Revenues	3.8	6.6	a	10.4	4.8%	0.4%
Total Budgetary Cost	**27.7**	**18.9**	**59.5**	**106.1**	**49.3%**	**4.5%**

a: Not estimated

In present value terms, the total estimated budgetary cost of not privatizing Egypt's state-owned companies addressed in this study is, quite conservatively, in excess of LE 100 billion. Assuming most of this budgetary benefit could be realized over the next five years by moving to an aggressive privatization program, Egypt's aggregate budget deficit over that period could be cut almost in half, reducing it by 4.5% of GDP, from 9.2% to 4.7%. These are enormous savings, amounting to 20% of Egypt's total supply of finance over the next five years. Part of this benefit could be reallocated to needed social programs, and the rest would release substantial domestic savings for private business finance.

In all three sectors, the operating results of these state-owned companies imposes a cost to the GOE. This poor profitability arises from two main causes: operational inefficiency under government management, and the inability of the state as owner to fund needed capital investment for up-to-date technology, because of its strained financial position. Only the private sector is capable of marshalling the financial resources needed to provide essential technology for Egypt's public enterprises and utilities. We estimate that privatization of these companies could lead to at least LE 50 billion in additional capital investment in Egypt over the next five years, a significant portion of which would come from FDI.

3. Macroeconomic Costs of Not Privatizing

In our study we look at the macroeconomic costs of not privatizing from three different points of view. First, we examine the performance of the Law 203 companies in aggregate, relative to that of Egypt's private sector. Second, we compare the overall macroeconomic performance of Egypt to those of other countries with slower, similar, and faster reform policies. Finally, we contrast Egypt's own macroeconomic performance in its years of ambitious privatization versus that of the recent years of little progress, in order to project prospective performance under alternative privatization policies.

3.1 Aggregate Performance of State-Owned Companies

Egypt's state-owned companies perform substantially worse than do its private companies. Nominal revenue growth of the Law 203 companies averaged only 2.3% annually the latest three-year period, negative in real terms, compared to 8.5% nominal for the aggregate private sector, and their total profitability has been negative. Had they been privatized and achieved the average performance of the rest of the private sector over this period, we estimate that they might have lost no jobs overall, even after needed right-sizing at overstaffed firms. Their profit taxes would have financed 3.0% of the 2002 central government budget deficit, instead of the actual 1.8%.

Adding all of the state-owned utilities and economic authorities, the banks, other industrial holdings to the Law 203 companies, total output of the public sector in Egypt is over LE 100 billion, some 30% of GDP. Of this amount, over two-thirds – 21% of GDP – is privatizable. (The balance is true government services.)

Table 3: **State Share of GDP**

	2001/02	% of Tot	% of GDP
Goods & Services	39.4	37.3%	11.1%
Petroleum Products	22.2	21.0%	6.3%
Agriculture, Industry & Mining, Construction, Trade, Hotels & Restaurants, Other Manufacturing	17.2	16.3%	4.9%
Utilities	19.3	18.2%	5.4%
Suez Canal	8.0	7.6%	2.3%
Telecommunications, Electricity, Airlines, Shipping, Water, Other Utilities	11.3	10.7%	3.2%
Finance & Insurance	15.0	14.2%	4.2%
Subtotal Privatizable	**73.7**	**69.7%**	**20.8%**
Government Services	32.0	30.3%	9.0%
Total	**105.7**	**100.0%**	**29.8%**

Source: Ministry of Foreign Trade

Adding to this dominant share in production the influence it exerts through its ownership position in 500 joint venture companies, its influence on companies receiving loans from state-owned banks, and its control of prices and wages in many sectors, the GOE is very likely to manage the majority of the economy. If we extrapolate the clear underperformance

of the Law 203 companies to this substantial share of GDP that is controlled by the state, the cost of not privatizing is multiplied.

3.2 Cross-Country Comparison and Egyptian Growth Simulation

The following table summarizes the results of our study's comparison of Egypt's economic performance with that of rapidly privatizing countries. We simulate what Egypt's economic performance could have been over the past decade, counterfactually assuming that it could have performed partially (conservative case) or fully (best case) as well as did the aggressive privatizers, had it adopted an equally aggressive liberalization strategy.

The following table summarizes this analysis:

Table 4: **Simulated Macroeconomic Performance Costs of Not Privatizing**
Decade to 2002

	Actual	**Potential**	
		Level	*Gain*
Annual Real GDP Growth	4.4%	5.5%	*25%*
GDP / Capita (PPP basis)	$3,700	$4,050	*10%*
Employment Growth, millions	4.4	5.1	*17%*
Unemployment Rate	9.4%	6.0%	*-36%*
Cumulative FDI, $ billions	$10.7	$22.2	*108%*

In a conservative scenario, which assumes that Egypt could have made up just half of the difference between its GDP per capital growth rate and that achieved by the aggressive privatizers (proxied by Poland), average annual GDP growth over the past decade could have been 25% higher than it actually was – 5.5% instead of 4.4%. On a purchasing power parity basis, even after allowing for the sizeable expansion in Egypt's population over the period, GDP per capita could have been over 10% higher than it was, at $4,050. As for employment, even after providing for a substantial increase in overall labor productivity, 800,000 more new jobs could have been created – 5.1 million instead of 4.4 million. *This increase would have more than absorbed the increase in the labor force over this period, leaving the unemployment rate at 6.0%, instead of the 9.4% actually experienced.* With respect to foreign direct investment, even if Egypt had achieved only one-third the performance of the aggressive privatizers, we estimate that at least twice the amount actually received could have been attracted – over $22 billion instead of about $11 billion.

3.3 Employment and Privatization in Egypt

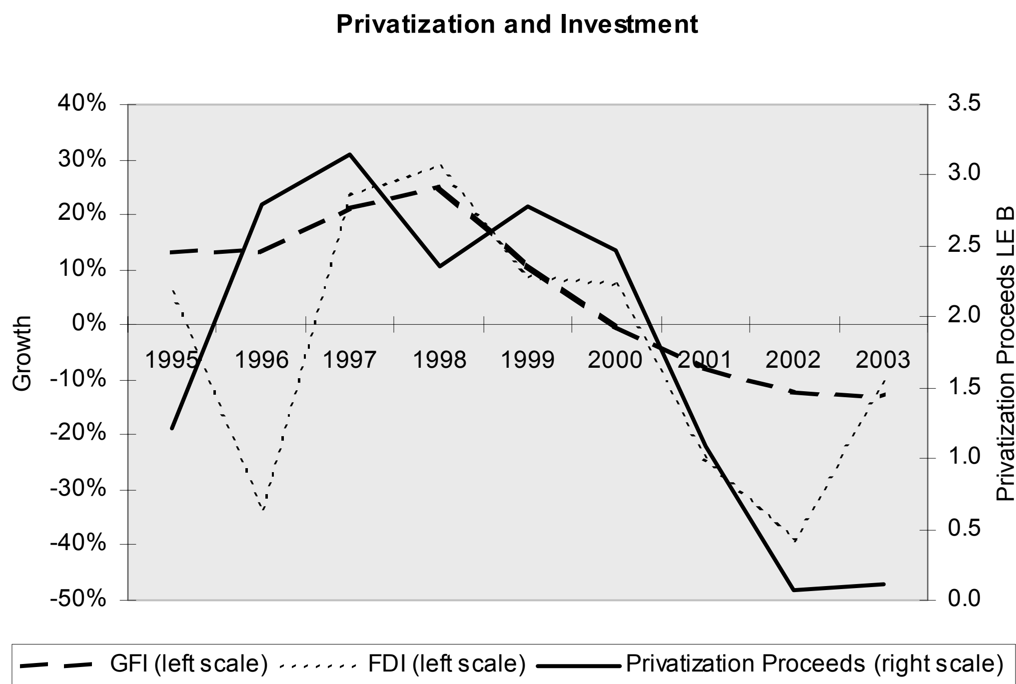
We looked closely at Egyptian sectoral employment trends, in order to determine the extent to which privatization-related restructuring might seriously affect Egyptian labor. We found that the reduction to date in employment of privatizable and privatized companies has been much more than offset by increased employment in the private non-agricultural sector, which has risen by at least 1.7 million, or 36%, in excess of the 31% growth rate of the total labor force.

Privatization is not the real problem for overall Egyptian employment growth. The real issue is the welcome modernization that is finally occurring in Egyptian agriculture, so growth in agriculture sector employment has been much slower than growth in the labor force. The non-agricultural sector needed to add over 1 million jobs in the past decade – 2.7 million jobs, instead of the 1.7 million it actually created – just to absorb labor force growth that could not be taken up by the agricultural sector. This is a significantly greater problem than labor shedding in overstaffed privatizing enterprises.

The ability of the private non-agricultural sector to generate employment depends crucially on overall economic liberalization. For Egypt to have any chance of addressing its burgeoning secular employment problem, the private sector must be freed from government economic management, market entry greatly eased, SME finance stimulated, and competitiveness encouraged. The only other option – employment absorption by the state, which added 1.7 million new jobs over the decade (a growth rate of 72%) – will only worsen Egypt's other major macroeconomic problem, a swelling public sector deficit. Furthermore, with government services by far the fastest-growing component of total employment over the past ten years, Egypt now has three times the share of public sector employees in its total labor force as do other countries in its development cohort, such as Turkey, Mexico, and Indonesia. Only Nigeria is marginally worse.

3.4 Macroeconomic Costs and Egypt's Own Privatization Experience

Though we did not construct a general macroeconomic model for Egypt in this study, we can observe relationships among key economic time series in Egypt over the past decade, and from this form quantitative estimates of impact. The following chart shows gross fixed investment (GFI), foreign direct investment (FDI), and privatization proceeds in Egypt from 1995-2003.



This chart shows an unmistakable correlation between these three variables. During the time of more aggressive privatization in Egypt, 1996-99, foreign direct investment rose strongly, and with it overall gross fixed investment. When privatization activity thereafter collapsed, the growth of both FDI and GFI became substantially negative.

The following observations on these relationships drawn from the Egyptian data guide specification of coefficients in some simple macroeconomic relationships for Egypt.

- *Privatization and FDI.* As reviewed above, at least one-fourth of Egyptian FDI over the past decade is accounted for by privatization. While the relationship between privatization proceeds and FDI shows significant variability, the elevated privatization proceeds of the late 90s clearly correlate to relatively high FDI in those years, and the sharp decline in privatization proceeds in the early 2000s correlates with negative FDI growth then.
- *FDI and GFI.* The chart shows that the late 90s period of more determined privatization and higher FDI also saw relatively robust growth in overall gross fixed investment in Egypt. Between 1993 and 1999, annual GFI more than doubled, from LE 25 billion to almost LE 60 billion. But as privatization slowed and FDI fell in the subsequent five years, GFI stagnated, rising hardly at all to LE 63 billion in 2003.
- *GFI and GDP.* GDP growth in Egypt also declined sharply over the decade under review. The ratio of GDP to GFI shows substantial stability over time. The trend in the growth rate of GDP has declined at about half the rate of the trend in the growth rate of GFI.
- *Employment and GDP.* We project employment by dividing our estimates of GDP by trend GDP per employee, a broad measure of productivity. Productivity growth measured on this basis has declined from an average of 8.5% per annum in the late 90s to 4.5% per annum in the early 2000s. In the aggressive privatization case, we assume faster productivity growth than in the status quo case.

The following table summarizes our results from projection of this model under the two scenarios.

Table 5: **Egypt Macro Projection**
Annual Averages, LE billions

	Actual		**Projected 2004-08**	
	1996-00	2001-03	Slow Pvtz	Rapid Pvtz
Privatization Proceeds	2.7	0.4	0.7	4.9
Foreign Direct Investment	3.4	2.3	2.8	6.1
Gross Fixed Investment	52.4	61.0	65.8	106.5
Nominal GDP	281.1	379.6	469.0	596.7
Nominal GDP growth	*10.7%*	*5.6%*	*5.5%*	*13.8%*
Employment Growth *000*	499	173	266	662
Unemployment Rate *(period end)*	7.9%	11.1%	14.5%	5.8%

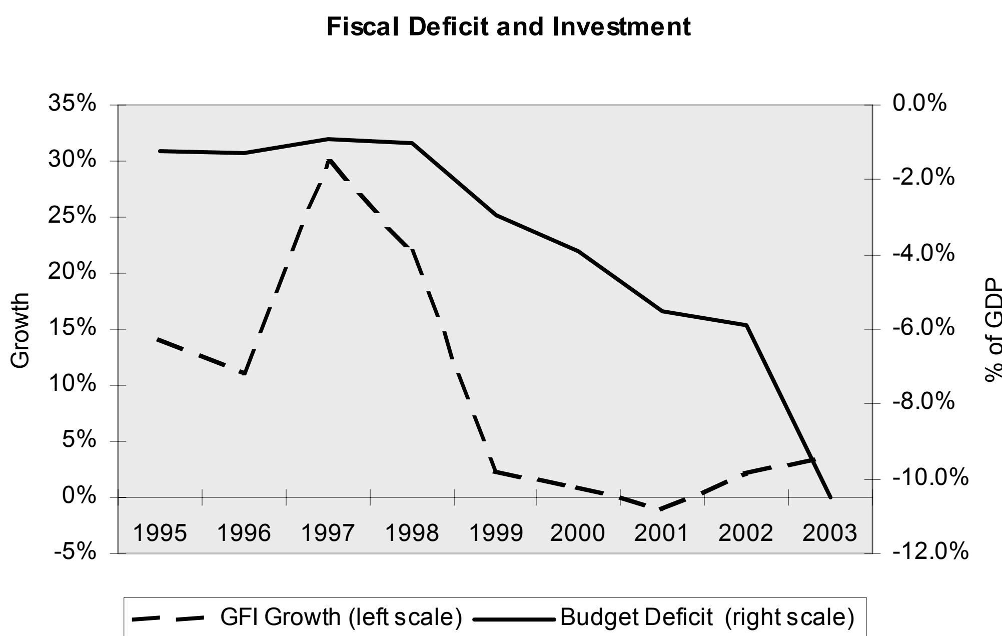
The projected slow privatization scenario basically carries forward the status quo experienced over the past three years, with moderate increases in privatization proceeds, FDI, and GFI, compared to the 2001-03 period, leading to a continuation of slow growth in GDP. As a result, average annual employment growth is less than 300,000, versus prospective annual labor force growth of 470,000. The unemployment rate ends up rising to 14.5%.

The rapid privatization case is constructed so that the great majority of presently privatizable assets are sold within the next 3-4 years. With average annual privatization proceeds rising

to almost LE 5 billion, some LE 25 billion would be raised over the five-year projection period. This would help generate a surge in FDI, to an annual average of LE 6 billion (about $1 billion at projected exchange rates). This in turn would be associated with a resumption of the expansion of GFI at the rates experienced in the rapid privatization period of the 90s, prompting a much faster expansion of GDP. As a result, even with higher productivity growth associated with greater economic efficiency, employment growth could be expected to rise by over 600,000 per year, providing for a sharp decline in the unemployment rate to 5.8% by the end of the period.

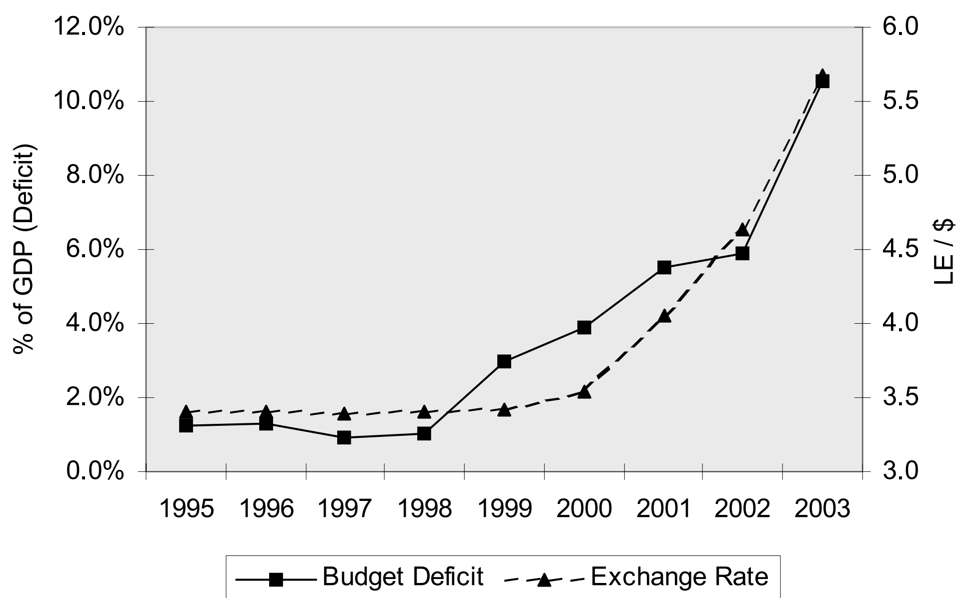
These results, based on Egypt's own actual experience, are broadly consistent with those in Section 3.2 above, generated in an entirely different manner by simulating Egyptian macroeconomic performance at the level of rapid privatizing countries such as Poland.

Another way of connecting our estimate of the budgetary cost of not privatizing to macroeconomic performance is to observe the correlation between the GOE budget deficit and the growth of gross fixed investment, as displayed in the following chart:



This chart illustrates for Egypt the well-established "crowding out" effect of excessive government borrowing on private credit. It shows that the stagnation in the growth of gross fixed investment in Egypt corresponds to the sharp deterioration in Egypt's central government budget deficit over the past five years, from approximate balance to negative 10% of GDP this year. In our microeconomic analysis, we estimated LE 100 billion as the budgetary cost of not privatizing over the next five years, an amount that represents 4-5% of GDP over this period. This would keep the overall budget deficit under substantial pressure and prevent a recovery in domestic investment. If reversed under an aggressive privatization program, the aggregate budget deficit could instead be reduced by 50%, and the availability of finance to the private sector increased by up to 20%, creating the conditions for a resurgence of domestic fixed investment.

Finally, the substantial budgetary impact of not privatizing would appear to have significant implications for the Egyptian pound exchange rate, as suggested by the following historical chart:



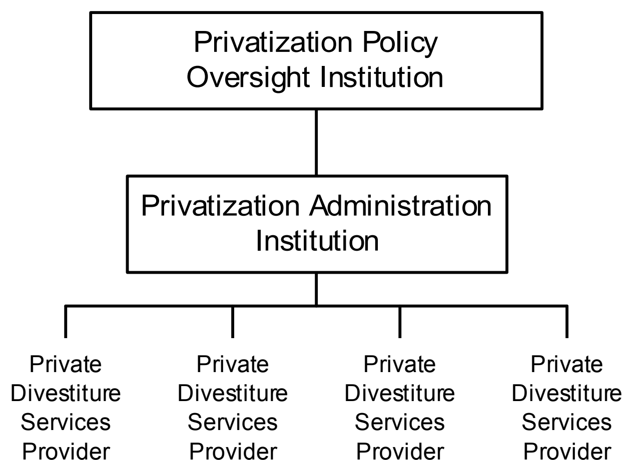
There is a striking correlation between the Egyptian central government budget deficit as a percent of GDP (expressed as a positive – i.e. a higher value means a higher deficit/GDP) and the Egyptian pound exchange rate. The statistical correlation coefficient between these completely unadjusted series is 0.95. This relationship works through the effect of budget deficits on monetary growth and inflation pressures, and through the impact of deteriorating government finances on the confidence of foreign investors and domestic savers in the value of the currency. Indeed, as the budget deficit has expanded from under 4 percent of GDP to over 10 percent in recent year, money growth has surged from 2 percent in 2000 to over 12 percent in 2003.

4. The Privatization Institutional Structure

We demonstrate in our study that gradualistic privatization carries substantial costs for the Egyptian economy, and that aggressive privatization would produce major benefits. For aggressive privatization to achieve its goals of speed and social equity, a proper privatization institutional structure must be in place. There are two broad sets of privatization institutions: those implementing privatization itself, and those facilitating the economy's adjustment to privatization.

4.1 Privatization Implementation Institutions

Privatization implementation institutions are the set of government bodies and agencies which authorize and execute privatization transactions. The following diagram represents these institutions in simplest terms:



There are three primary functional areas in privatization:

(i) *Privatization policy*; i.e., general oversight to interpret public policy and ensure that privatization is carried out according to it, which is the responsibility of the Privatization Policy Oversight Institution (a ministerial committee, ministry, or other apex authority body)

(ii) *Privatization administration*; i.e., administrative organization and supervision of the privatization process, which is the responsibility of the Privatization Administration Institution (an independent agency, a department in a ministry, a related body with administrative authority, etc.), and

(iii) *Privatization execution*, i.e., implementation of privatization transactions, largely the responsibility of private sector experts engaged under clear mandates in competitive tenders.

In our study, we use the above broad framework to evaluate Egypt's privatization institutional structure, and to compare it to those of selected other developing and transition economies who have gone through and are going through the privatization process. We find that privatization implementation institutional structures vary significantly. The aggressive privatizers have the simplest structures, with a single apex body (such as a ministerial committee) involved primarily in policy, sometimes with a consent role for the largest transactions. Their privatization administration agencies have a clear mission to sell companies, a great deal of transactions authority, no role in the management of state-owned companies, and a practice of distributing the bulk of privatization execution work to private sector experts.

The slow privatizers tend to have much more complex privatization implementing institutions. Apex policy authority is diffuse and conflated with privatization transactions implementation. Roles and responsibilities across the institutional structure are often severely overlapping, with responsibility handed from agency to agency and back. The result is indecision and extreme delay in implementing privatization. We find that Egypt's privatization implementation structure has many of these characteristics, and therefore accounts in part for the severe slowdown in privatization activity in recent years.

4.2 Post-Privatization Facilitating Institutions

When the lead in economic growth is turned over to the private sector, government relinquishes its economic management function, but retains its welfare protection function. Government must establish institutions which facilitate privatization by ensuring that the welfare issues which privatization creates are addressed.

There are four basic institutional areas for facilitating privatization.

(i) A commercial legal and regulatory environment that is friendly to new business creation (minimizes red tape) and promotes competition and free entry into all commercial sectors.

(ii) A labor legal and regulatory environment that promotes flexibility and mobility by giving employers reasonable rights in laying off workers and unobstructed hiring rights.

(iii) A mutually-reinforcing set of transitional social support programs that dovetail closely with privatization-related employment reductions.

(iv) A utilities regulatory regime that mandates core pricing and service provision requirements for private producers of essential widely-used goods and services, and a competition policy regime that prevents monopolistic concentration of economic power in other industries.

Countries with institutions in place have been able to implement aggressive privatization programs while minimizing social unrest. Egypt needs to accelerate reforms in all four areas.

5. Major Conclusions

We believe that Egypt no longer has any choice but to abandon statism and move aggressively toward privatization of state-owned industrial companies, banks, and utilities, and overall economic liberalization (including the establishment of proper privatization facilitation institutions). In three major areas, spanning the economy, present trends suggest Egypt is heading for a crisis, if it is not already in one.

- Employment: The major shift in Egypt's historical employment patterns, means that the rural sector is no longer an engine of employment growth. Because of continued obstacles to free enterprise created by the state, private non-agricultural sector growth has not been sufficient in Egypt. The GOE's reaction has been to try to take up the slack itself, becoming the fastest-growing employment sector over the past decade. This is clearly unsustainable, because eventually it leads to excessive fiscal deficits, as we are now seeing. Only rapid private sector expansion can solve this problem. Set against these basic trends, labor shedding from overstaffed state-owned companies in the process of privatization is a secondary issue, that would be solved by addressing the primary problem.

- Business Finance: Business credit is of course essential for growth. However, Egypt's financial sector is dominated by the state-owned banks and nonbank financial intermediaries. The state-owned banks cannot operate effectively because they have mixed commercial and welfare objectives. The latter leads them to undertake concessional lending, especially to companies with state ownership, many of which become nonperforming. We estimate that bank bad debt provisions are half of what they should be, and that the state-owned banks are severely undercapitalized. This substantially restricts their ability to create commercial business finance, and since they account for half of the banking sector in Egypt, this

is a severe problem for the economy at large. Furthermore, the dominance of the Egyptian financial sector by state institutions has chilled financial innovation, so that despite the liquidity of Egyptian banks, SMEs do not have ready access to affordable credit. Only aggressive privatization of the Egyptian financial sector can align its organization and incentives to the economy's needs.

- Productive Investment: Even if state ownership could be somehow justified on welfare grounds – which according to the now extensive empirical literature it cannot – we estimate in this report that the recapitalization needs of Egypt's state-owned industries, banks, and utilities are at least LE 50 billion over the next five years. Furthermore, we show that foreign domestic investment growth has reversed and overall gross fixed investment growth in Egypt has virtually stagnated with the collapse in privatization activity. It is widely recognized that widespread underinvestment in technology is a fundamental problem for Egypt's competitiveness, and for its ability to provide adequate utility services for its populace. Only through private sector ownership can the massive capital investment needs of Egypt's industries, utilities, and banks be met.

Egypt must move aggressively to fulfill its stated policy, and to realize the unequaled potential, of private sector-led economic growth.