TAPR IQC Egypt
Technical Assistance to Support Economic Policy Reform
USAID Contract No. 263-Q-00-97-00104-00
Deliverable for Task Order 1 - Delivery of TAPR Core Management Team

The Development of a Reformed Egyptian Economic Processing Zone

Submitted to:
United States Agency for International Development

Submitted by:
Chemonics Interntaional Inc.

c. 2000

THE DEVELOPMENT OF A REFORMED EGYPTIAN ECONOMIC PROCESSING ZONE

I. SUMMARY

Background: EPZs elsewhere in the world are now generally called "Economic Processing Zones." This reflects the fact that the emphasis has shifted from subsidizing the expansion of exports and foreign exchange earnings, to recognition of the EPZ role as a cutting edge in increasing processing efficiency and employment in host countries. The potential benefits of EPZ programs are both direct and indirect. Direct benefits, include increases in efficient production and employment and the additional exports and family incomes attendant to these. Indirect benefits, in the form of hastening and smoothing the adoption of reforms to Egypt's incentive system economy-wide, are also possible and are of potentially greater significance.

Current Status of Egyptian EPZs: Imports and exports have grown only modestly in value for all the Free Zones taken together. Indeed, the value of exports has grown slower than imports, with the result that the import to export ratio, which was just over one in 1995, grew to 1.5 by the end of 1998. In contrast to EPZs in many countries, the investment process in Egypt is beset by administrative encumbrances. The fiscal (tax) incentives granted under Law 8 are attractive. However, as the slower growth of new investment in the Free Zones shows, neither the Law 8 incentives, nor the Free Zone exemptions from customs duties, fees, etc. are sufficient to offset the severe administrative procedures that new investors face. In addition to administrative barriers, new investors, within and outside the Free Zones in Egypt receive no preferential treatment regarding the provision and cost of infrastructure. This applies to both "hard" social goods such as electricity, water, transport, telecommunications, port handling, etc, and "soft" social goods such as training and international marketing.

International Best Practices: Successful EPZs are differentiated from the general investment/production environment by virtue of three characteristics. First, they usually grant, in varying degrees, "soft" or financial incentives. Budgetary subsidies may consist of government provision of all or part of the cost of production-relevant "software" such as training, etc. Much more frequently, the financial incentives consist of the provision of implicit subsidies such as tax and fee exemptions, holidays, etc. These have become fairly standard, worldwide so that they do not contravene WTO agreements. Second, EPZs receive quick access to high quality physical infrastructure such as utilities, transport, etc. Finally, and most significantly EPZs usually receive special treatment with respect to governmental administrative procedures and practices. **In general the standard for the extent of administrative intervention is an international one, established in successful EPZs in other countries. Administrative interventions should be reduced to an international level or standard, not just reduced "substantially." Experience shows that all three types of inducements are necessary to one degree or another, depending on a country's initial conditions.** Attempting to trade off amongst the three types of inducements doesn't work. That is, it is not effective to, e.g., double the length of a tax holiday in order to try to compensate for administrative interventions that are excessive by international standards.

Previously, governments tended to own and manage the industrial estates that were designated as EPZs, although the processing activities were mostly private. This proved to be unsuccessful

except in a limited number of cases primarily involving quite strict commercial relationships between the government and the investors. Increasingly, many of the components of newer EPZs are privately owned, primarily because the yields to such private investments are attractive and because privatization has resulted in dramatic improvements in the management, operation and success of EPZs. It is significant that mechanisms such as BOOTs and BOTS are ideal for privatizing EPZs and their associated components. In this context, the role of the government is to provide policy incentives, such as tax and tariff, and to eliminate administrative obstacles to investment and commercial activity.

Next Steps:

- Detailed assessment of current Egyptian EPZ incentives and applicable laws, regulations, and administrative procedures. (Partially completed)
- Comparison of Egyptian practices with international best practices. (Partially completed)
- Identification of revisions in Egyptian practices needed to meet international best practices.
- Design of privatized approach to EPZ operation, management and ownership.
- Decision as to whether the new approach to EPZs should be on a pilot basis or for all EPZs.
- Preparation and implementation of a plan that will put in place the agreed upon new rules and procedures.

II. THE PRESENT EGYPTIAN INCENTIVE ATMOSPHERE AND FREE ZONE EXPERIENCE.

A. The Incentive Atmosphere

The incentive system affecting private economic behavior in Egypt is recognized by the GOE as requiring further reform. A primary contributor to the weak incentive system are the remaining government interventionist policies. These frequently involve discretionary, selective administration of regulations and policies and directly stifle private economic incentives. The result is a lack of domestic competition, inefficient production, poor labor productivity and low private sector investment and employment. These shortcomings have led to below-potential growth in GDP and employment and to labor productivity that is so low that many of those who are employed take home earnings that keep them below the poverty line.

Egypt's investment and trade incentive system has been extensively studied. Separate examinations relate to the tax and trade regimes, investment incentives, export potential, and agricultural and industrial production and employment. There is a growing general consensus that there is an urgent need for administrative reform and to maintain the momentum of policy reform. A generalization would be that policies must become more sympathetic to private investment and initiative and be accompanied by across-the-board reductions in the size of public sector interventions into economic activities.

Ongoing Reforms and Prospects. A reform momentum has developed in Egypt. It is an across-the-board or economy-wide reform effort, which consists of a set of possible reform measures that are applied economy-wide. Implementation of these is sequenced in such a way that the pace of reform is controlled or deliberate, rather than comprehensive and instantaneous. Partial reform programs, even if applied economy-wide, will always be chosen over all-encompassing reform programs. Total, instantaneous deregulation, or all-encompassing programs in which the whole menu of reform measures is instantaneously applied economy-wide, have theoretical merit, but are generally seen as simply too politically risky for any government to try.

This has led to questions regarding whether there are other approaches, besides total, instantaneous, economy-wide deregulation or partial, economy wide, deliberately sequenced, policy reform programs. In other countries it has been found that a program establishing appropriately designed and managed EPZs can be an excellent complement to the partial reform approach. This EPZ approach amounts to targeting the reforms. It is similar to what is called 'deregulation' in mature economies.

B. The Free Zone Experience in Egypt.

Historical Background. Egypt has had a variation of EPZs, called Free Zones, for several years. They emerged following the passage of the investment promotion law No. 230 of 1989. This law created the General Authority for Investment (GAFI) which was charged with vetting new investment applications, aiding new investors, and administering several fiscal (mainly tax-related) investment incentives. Under Law 230, GAFI was given authority over Free Zones, or areas or sub-sectors that were granted relief from certain customs duties and fees, but not from most customs related administrative procedures.

Law 8 of 1997 superceded Law 230. This new law clarified and to some extent streamlined new investor procedures and incentives, but it ignored any outstanding issues affecting Free Zones. In particular, no clarity was introduced regarding how GAFI might differentially favor free zone development. GAFI formed a Free Zone Agency under its authority, which mainly facilitates interactions between GAFI and new Free Zone investors. In particular, neither GAFI, its Free Zone Agency, nor other government departments direct the targeting of special administrative treatment and/or infrastructure access to new investors, within or outside the Free Zones. As a result, Free Zones in Egypt mainly attract Egyptian traders desiring to avoid cumbersome duty and fee drawback schemes promulgated under the Customs Laws.

Table 1. Distribution of Capital for All Free Zones (%)

Distribution by Free Zone		**Distribution by National Origin**	
Alex	23%	Egyptian	80%
Port Said	4%	Arab	9%
Nasr City	7%	Asian/African/Australian	1%
Suez/Ismailia/Damietta	14%	European	8%
Private (sub-sectors)	52%	Americas	2%

Source: GAFI.

There are two types of Free Zones in Egypt. Six are estates, where several companies group together. There are also free zone companies or projects in various sub-sectors. These are called "private" Free Zones. Most of the activity in the free zones is not really processing. Many of these investments are new branches of existing Egyptian businesses. These are located in the Free Zones in order to facilitate the duty free import of goods that are then "exported" to a branch outside the Free Zone, but within Egypt.

Imports and exports have grown only modestly in value for all the Free Zones taken together. Indeed, the value of exports has grown slower, with the result that the import to export ratio, which was just over one in 1995, grew to 1.5 by the end of 1998. For all Free zones, it is estimated that roughly 28,000 jobs have been created, again, a modest figure by international and rest-of-Egypt standards.

In contrast to EPZs in many countries, the investment process in Egypt is beset by administrative encumbrances. The fiscal (tax) incentives granted under Law 8 are attractive. However, as the slower-than-average growth of new investment in the Free Zones shows, neither the Law 8 incentives, nor the Free Zone exemptions from customs duties, fees, etc. are sufficient to offset the severe administrative procedures that new investors face.

In addition to administrative barriers, new investors, within and outside the Free Zones in Egypt receive no preferential treatment regarding the provision and cost of infrastructure. This applies to both "hard" social goods such as electricity, water, transport, telecommunications, port handling, etc, and "soft" social goods such as training and international marketing. Elsewhere, the decision to target infrastructure favors and administrative exemptions to investors has resulted in much faster growth and greater, more widely distributed availability of infrastructure in the longer run. In the initial phases of development it is, therefore, the concentration of favors within free zones, rather than the extent of them throughout the economy, that can stimulate more private investment and domestic savings.

Even though Egypt is geographically very well located to be competitive and has abundant labor, the free zones have not attracted significant amounts of efficient, technologically advanced investment in outsourcing, or activities that are part of an international production chain. One result is that employment and labor productivity and earnings have not grown at rapid rates. Another is that the existing Free Zones have not become showpieces of reform success. The result is that Egypt has yet to experience the impact of a well-designed and implemented Free Zone or EPZ Program.

III. THE INTERNATIONAL EPZ EXPERIENCE & DERIVED BEST PRACTICES

Within the last decade or so EPZs have evolved in two crucial ways. First, it is increasingly the case that EPZ status is targeted to certain processing sub-sectors throughout an economy instead of only to geographical areas or industrial estates within it. Second, the design of EPZs has been adapted to reflect the rapid expansion of outsourcing or sub-contracting activity throughout the world economy. This has led to adjustments tailored to increasing the role that EPZs play in the international processing chain.

Design. Successful EPZs are differentiated from the general investment/production atmosphere by virtue of three characteristics. First, they usually grant, in varying degrees, "soft" or financial incentives. These rarely involve direct cash transfers. Instead, such budgetary subsidies consist of government provision of all or part of the cost of production-relevant "software" such as training, etc. Much more frequently, the financial incentives consist of the provision of implicit subsidies such as tax and fee exemptions, holidays, etc. These have of late become fairly standard, world-wide so that they do not contravene WTO agreements. Second, EPZs receive targeted "hard" incentives most notably, privileged access to physical infrastructure such as utilities, transport, etc. With only rare exceptions, the principles guiding the targeting of infrastructure preferences to EPZs should be applicable throughout the economy to all potential investors although at later dates, as necessary.

Finally, and most significantly EPZs usually receive special treatment with respect to governmental administrative procedures and practices. Such special treatment involves exemptions from or relaxation and/or streamlining of those government administrative practices that increase the time requirements and costs of doing business. These administrative reforms might be called, more comprehensively, targeted deregulation. For example, EPZ investors might be granted fast-track import and export privileges and less "sticky" profit repatriation rights. **In general the standard for the extent of administrative intervention is an international one, established in EPZs in other countries. Administrative interventions should be reduced to an international level or standard, not just reduced "substantially."** Experience shows that all three types of inducements are necessary to one degree or another, depending on a country's initial conditions. However, generally speaking, attempting to trade off amongst the three types of inducements doesn't work. That is, it is not effective to, e.g., double the length of a tax holiday in order to try to compensate for administrative interventions that are excessive by international standards.

Additional design issues relate to how EPZs and EPZ programs are to be managed and operated. Of most significance is that the design of EPZs and EPZ programs is flexible and responsive to the commercial needs of EPZ investors as they evolve. This suggests the need for an independent EPZ organization or association that has the authority to react quickly to altered commercial circumstances and that has access to and influence with GOE's policy machinery.

Ownership of EPZs. Previously, governments tended to own and manage the industrial estates that were designated as EPZs. Most frequently both the land and infrastructure associated with EPZs were government owned, although the processing activities were mostly private. This proved to be unsuccessful except in a limited number of cases primarily only those involving quite strict commercial relationships between the government and the investors. Increasingly, many of the components of later vintage EPZs are privately owned, primarily because the yields to such private investments are attractive. Thus there has been a particular progression in which publicly owned EPZs are first given the right to offer inducements such as those set out in the Design section above. Governments have then allowed privately owned industrial estates and or processing sub-sectors to extend similar inducements to new investors. In some countries, such as Kenya, private EPZs essentially take over from public ones. Privatization has resulted in dramatic improvements in the management, operation and success of EPZs. It is significant that mechanisms such as BOOTs and BOTS are ideal for privatizing EPZs and their associated components.

Management and Operation. It is easier to understand arguments for private management of EPZs than it is to appreciate the potential benefits of a privately managed program of EPZs. However, the EPZs and the program as a whole seem to benefit when governments take a hands-off attitude. What seems best is to have something like an Association of EPZs that is privately financed through subscription fees and that interacts with the relevant government agencies. This enables governments to concentrate on adjusting policies when and if the need is indicated and appropriately defended by an Association of EPZs.

Employment, earnings and work conditions. Successful EPZs can be thought of as islands of capitalism in the earlier stages of reform. Competitive labor markets will exist within, but not, initially, outside of EPZs. These EPZ, or "inside" labor markets have almost always provided two things. One is better earnings and working conditions for EPZ workers than for their counterparts in the outside economy. These counterparts are most frequently either unemployed or working irregularly in the informal economy. The other is earnings and working conditions that are internationally acceptable. One major reason for the better inside working conditions is the international nature of EPZ management and clients.

Impact on regional trade, cooperation and cohesion. Studies suggest that EPZs increase regional economic and political cooperation and cohesion. Increased cohesiveness comes from expanded regional trade, particularly greater trade in intermediate goods and services that are part of similar production chains. In essence, regional cohesiveness is most likely to increase with an expansion of outsourcing or sub-contracting amongst countries and/or EPZs within regional groupings. This means that the role EPZs would play in expanded cooperation and cohesion would depend on their role in reforming each country's incentive system. Of course national and regional stability also increases with growth in income, which, in turn, would occur more quickly and evenly as the reforms begin to take hold.

Best Practices. Although EPZs have a fairly standard set of (mainly fiscal) subsidies, the keys to success seem to lie in whether they are managed or administered in such a way that government intervention into markets and commercial transactions are reduced to levels applicable internationally. This usually involves revising commercially relevant laws and applying them more consistently and transparently. Bureaucratic interventions are best reduced to the point where corruption disappears and private firms have the freedom to adopt internationally acceptable commercial behavior. It appears that the more "private" the EPZ, in terms of ownership and management, the greater its chances of success.

Successful EPZs tend to involve the following. Governing legislation would best enable the establishment of industrial estates and/or processing sub-sectors as EPZs and would minimize government, in favor of private sector, EPZ ownership and management. A private-like, Association of EPZs financed through fee contributions from EPZ based firms, would interact with the GOE and the EPZs. A standard set of fiscal and infrastructure inducements would best be offered. Access to these would be open to all EPZ participants rather than being "selective." If selective, they would contravene the Uruguay Round WTO/GATT Agreement on Subsidies and Countervailing Measures. Among other things, this would mean treating foreign and domestic investors and enterprises equally with respect to access to, investment in, and use of EPZs.

Although there would be an emphasis on the need to export, some (designated but easily revisable) portion of output could be sold domestically. In the case of domestic sales, in the absence of a VAT, an automatically applicable (i.e., VAT-like) formula would be used to assess any applicable duties and taxes. Infrastructure, preferably provided indirectly (e.g., through BOOTs. BOTs, etc.), would reflect individual EPZ needs, as these are conveyed through an Egyptian EPZ Umbrella Organization. GOE financed infrastructure would be mainly privately provided (e.g. BOTs, etc,) and tailored to the EPZs' needs. These would involve the provision of appropriate physical and "software" (technology & training, etc.) capital.

IV. NEXT STEPS

The establishment of a productive, competitive Egyptian EPZ would involve the following actions:

- Detailed review of current Egyptian EPZ incentives and applicable laws, regulations, and administrative procedures. (Partially completed)
- Comparison of Egyptian practices with international best practices. (Partially completed)
- Identification of revisions in Egyptian practices needed to meet international best practices.
- Design of privatized approach to EPZ operation, management and ownership.
- Decision as to whether the new approach to EPZs should be on a pilot basis or for all EPZs.
- Preparation and implementation of a plan that will put in place the agreed upon new rules and procedures.

TAPR - RM/JN 1/27/00 11:30 AM