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by
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Egypt: The Environment for Adjustment to Trade Liberalization

Abeer Elshennawy*

Abstract

This paper investigated the potential effect of market failures in labor and capital markets in addition to market failure due to high transaction costs on the transitional path to trade liberalization. All three types of market failure were found to reduce the speed of adjustment to free trade and contribute to high adjustment costs. The paper also examined the consistency of the macroeconomic environment with the objectives of trade liberalization. It is postulated that a macroeconomic environment that is basically recessionary is likely to lead to high adjustment costs.

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Introduction

Free trade, a policy stance that is hardly new dating back to the classical economists has been traditionally advocated mainly on the basis of the conventional static gains from trade - those arising from a more efficient reallocation of resources - and owes its more recent revival to what has come to be known as the dynamic gains from trade - those arising from the reallocation of investment resources or in response to increasing productivity as emphasized in the new growth theories. However, while the theoretical evidence seem most compelling, moving from the realm of theory to practical implementation raises a number of concerns particularly for countries that have adopted inward oriented strategies over a relatively long period of time coupled with heavy reliance on tariff and non tariff barriers for the purpose of promoting an indigenous industrial sector. These concerns are basically related to the problems and costs of adjustment to trade liberalization.

None of the earlier or more recent theoretical models analyzing the gains from trade addressed or in any way accounted for problems of adjustment. Adjustment to trade liberalization was envisioned to take place in a perfect world, fundamentally one where markets work well. Within perfect markets, an economy adjusts instantaneously and costlessly - following trade liberalization - to a new position where either or both the level and rate of growth of income are higher. Relaxing the assumption of instantaneous and costless adjustment represented the point of departure between the theoretical and the empirical literature. Studying adjustment within a less than perfect world - particularly within imperfect labor and capital markets - became the main occupation of this latter line of thought. (See Banks and Tumir 1986; ECC, 1988; Mussa, 1982; Elshennawy, 1998.)

Although this body of literature remains to date relatively underdeveloped, it has nonetheless contributed towards a more understanding of the nature, causes and severity of the problems that might face an economy during the transition to free trade. A leading World Bank empirical study (World Bank, 1991) revealed that the transitional costs of adjustment to trade liberalization are usually manifested in rising unemployment rates, balance of payment problems and declining industrial output. Meanwhile, the magnitude of these costs depends on the nature of the economic environment - existing market arrangements, the institutional setting, macroeconomic policies etc. - within which trade liberalization is implemented.

In the absence of instantaneous and costless adjustment to free trade, an adjustment path that is both efficient and sustainable is necessary if the gains from trade are to be ever realized in practice. Only when the adjustment of sectors of the economy in response to trade liberalization proceeds at a speed sufficient to bring about a more efficient allocation of resources would the path of adjustment be considered *efficient*. A more efficient reallocation of resources occurs when any resources released from declining activities are absorbed by expanding activities in a fashion that maximizes transitional GDP. An efficient adjustment path is precisely one that maximizes the gains from trade, minimizes any transitional costs and one where GDP does not initially decline. On the other hand, a *sustainable* adjustment path is one where efficient export and import substituting industries are expanding at a rate sufficient to reduce any pressure on the balance of payment. That is a sustainable adjustment path would be associated with a reasonable path of debt to GDP ratio (Elshennawy, 1998). The *speed* of adjustment is the critical element in this analysis.

For example, empirical evidence reveals that the success of many trade liberalization attempts have hinged on the ability of efficient import substituting and expanding export industries to quickly absorb the resources released from declining industries. This minimizes pressure on the balance of payment and reduces the incidence of transitional unemployment. The World Bank study confirms that these are two of the main factors underlying the failure or at least the partial reversal of many trade liberalization attempts (Michaely, et al., 1991). Naturally, the speed - and in turn both the efficiency and sustainability - of adjustment will be influenced by the economic environment.

Studying the issue of adjustment costs to trade liberalization is especially relevant to the case of the Egyptian economy. For one thing, despite the fact that attempts to move from a centrally planned economy and state led inward oriented development strategy to a market oriented private sector led development took place since the early seventies, it was not until the late eighties and early nineties that the market mechanism actually started to govern the process of resource allocation. Although efforts to liberalize trade which began as early as 1986 have resulted in the elimination of almost all non-tariff barriers to trade as well as a reduction in the level and dispersion of tariffs, protection is still effectively binding given an average tariff level that is still considered relatively high by international standards.

Like the case of many developing countries that followed more or less the same route, much of both public and private investment in the industrial sector that took place behind trade barriers and in response to distorted prices have proved to be inconsistent with the country's comparative advantage. Given the lagging reform on the institutional front, it becomes increasingly unrealistic to dismiss the assumption that competition from imports might lead to sizable adjustment costs. Since the magnitude of these costs is correlated with the nature of the economic environment, it is imperative to study this dimension of the adjustment process in the context of Egypt's experience with trade liberalization.

In light of these considerations, some of the broad characteristics of the economic environment will be analyzed in this paper. Whether markets work well or not, is a question of central importance. To the traditional types of market failures acknowledged in the literature, this paper adds the class of market failures arising from high transaction costs as a possible factor influencing adjustment. The focus, in general, will be on identifying the constraints -if any- that might impede the efficient adjustment to trade liberalization and assessing the degree of consistency of the macroeconomic environment with the objectives of trade liberalization. The rest of the paper will be organized as follows. How market failures influence adjustment is taken up in section one. In section two the state of the working of markets in Egypt will be examined. Macroeconomic policies will be analyzed in section three. Finally, section four presents the conclusion.

Section I

Since the inception of the General Agreement on Trade and Tariffs (GATT) in 1947, reducing trade barriers became the top priority goal of the major industrialized countries. Successive rounds of negotiation over the span of almost half a century achieved little towards the complete elimination of these barriers. In anticipation of high adjustment costs, many countries developed or underdeveloped alike, either chose to abandon the whole idea of free trade, were slow to introduce trade reform or quickly opted for policy reversals as soon as problems of adjustment loomed ahead. The recurrence or persistence of problems of this kind suggests that more research is certainly needed to identify the factors underlying this phenomenon along with the appropriate adjustment policies before it becomes too optimistic to quest for a free world trading system.

Identifying the factors that lead to adjustment problems is no easy task. Research in this area dates back to the seventies and since then has not occupied much space on the economic research agenda. The existing body of literature which mainly consists of qualitative case studies concerned with specific regions - or specific industries in these regions - over specific time intervals makes it hard and in many instances infeasible to form broad generalizations regarding the nature of these factors. Consequently, assessing – *ex ante* – the likelihood of such problems arising or providing even the crudest estimates of the magnitude of adjustment costs continues to be almost impossible.

Nevertheless, the task of identifying the factors that lead to adjustment problems becomes less troublesome if it is possible to sketch the details of an ideal economic environment, one that facilitates the release of resources from lower to higher productive use and therefore minimize on the adjustment costs to trade liberalization. Deviations from this ideal environment points to the respective factors and provides grounds to anticipate adjustment problems *ex ante*. In other words, the factors responsible for these deviations are the very same ones that lead to adjustment problems. The larger are these deviations, the larger will be the magnitude of adjustment costs. Details of micro and macro nature are both relevant. Discussion of the macroeconomic details will be deferred to the section on the Egyptian economy. This is partly because they have been emphasized elsewhere (World Bank, 1991) and partly because it will be more illuminating to illustrate their importance with an actual case study. In contrast, the emphasis on some microeconomic details below is entirely new. Allowing for a more general exposition allows in turn for broader generalizations to the experience of other countries. Hence a separate section was necessary.

Adjustment to Trade Liberalization: Microeconomic Conditions.

It is beyond dispute that under conditions of perfect competition and perfect foresight, market forces will always provide the most efficient adjustment mechanism through signals embedded in changing relative prices and job opportunities. The reallocation of resources - under these conditions - will be *frictionless and instantaneous* (Bank and Tumlir, 1986) precisely because markets are presumed to work well. There are no barriers to entry and exit, prices are sufficiently flexible, information is perfect, externalities are absent and the cost of market contracting is zero. Even the most basic of institutions e.g. firms, money, public regulations etc

become irrelevant in this setting basically because the optimality of the perfectly competitive system rests in part on the assumption that institutions do not play any role in the determination of equilibrium prices (Furubotn and Richer, 1991).

In this environment, firms will contract or exit if losses are incurred while more efficient firms will expand and new entry will occur as profitable opportunities persist or widens. Losses can be merely incurred due to unfortunate circumstances or can simply reflect the release of resources into more profitable uses. The rate of exit or decline which thus occurs independently of economic conditions prevailing (like a recession) can be defined as the *natural rate of decline*. The reallocation of resources will be frictionless and instantaneous, but will nonetheless involve costs that are inevitable and are to a large extent part of the working of the market economy where success is rewarded and failure penalized (ECC, 1988).

Recognizing the limitations of this ideal economic environment, which being neoclassical in spirit abstracts from many of the realities of the economic system, particularly from institutional structure, - a factor that is known to influence both incentives and behavior - (Furubotn and Richer, 1991) provides the starting point in the analysis of adjustment problems to trade liberalization. In reality, markets can and do fail and institutions influence incentives and behavior all of which will have profound implications for, the speed of adjustment, the properties of the adjustment path to trade liberalization and the magnitude of adjustment costs.

The main point is that as we move to environments where markets are imperfect (labor, capital and product markets) uncertainty and risk increases and prices loose much of their informational content (Bank and Tumlir, 1986) creating distortions to the adjustment process. Problems of adjustment typically occur when distortions and presumably the lack of perfect foresight, create divergence between the private and social perceptions of the costs and benefits of adjustment, preventing -in turn- the optimal allocation of resources. In this case, not only will the adjustment process be less than instantaneous, but instantaneous adjustment might not be the socially optimal policy (Mussa, 1982).

Many of the factors that impede the working of the market mechanism are institutional in nature. Allowing for more institutional detail in the analysis is essential to understanding problems of adjustment in general. Relaxing the assumption of zero cost of market contracting is considered a potentially powerful factor that contributes to the deviation of the social benefits

and costs of adjustment from the private costs and benefits. Considering this category of market failures provides more scope to analyze and emphasize the influence of the institutional environment and institutional arrangements on the path of adjustment to trade liberalization. We will begin the discussion by the more traditional types of failure in factor markets.

1.1 Labor Market Failures

Sources of market failures in labor markets are numerous, ranging from the asymmetry of information about the future pattern of comparative advantage, externalities in the accumulation of human capital - which is usually responsible for under investment by both employer and employees in firm specific skills -, to congestion problems that increases the costs of search by workers (Trebilcock, et al., 1990).

A number of institutional factors can further inhibit the efficient working of the labor market. On the demand side, these include wage rigidities due to wage indexation or pressure from labor unions in addition to social security regulations which constraint the ability of firms to alter the size of their labor force especially where adjustment entails downsizing. Other restrictive practices include cumbersome administrative dismissal (and hiring) procedures which usually provides wide scope for government intervention (Banks and Tumlir, 1986). Market failures also arise when pensions deter firms from hiring elderly workers (Wonnacott and Hill, 1987). On the supply side, a number of studies have confirmed that unemployment insurance (especially for unskilled workers) and the subsidization of housing costs in certain regions can reduce the incentives for dislocated workers to seek reemployment in regions other than their home ones (Banks and Tumlir, 1986).

1.2 Capital Market Failures

Inadequate collateral or credit rationing are among the leading causes of market failures in capital markets. This implies that some borrowers will be rationed out of the capital market constraining their ability to finance investment for expansion or restructuring. The credit constraint is likely to be even more binding for labor where funds are needed to cover the costs of retraining or reallocation (Wonnacott and Hill, 1987).

Like wise the case with labor markets, several institutional factors contribute to imperfections in capital market. Complex systems of taxation render the process of ranking alternative investment opportunities according to private and social profitability intrinsically

difficult. In environments characterized by excessive inflationary pressures, a tax system where depreciation allowances are based on historical values of the capital stock reduces the after tax profitability of investment and tilts it in favor of short term projects. Investment demand can be also curtailed when regulations that restrict market entry encourage collusive behavior on behalf of lending institutions and consequently lead to high interest rates. Low administered interest rates reduce the volume of savings and thus available finance. The cumulative effect of these policies tends to reduce the sources of mobility in the capital stock, both the outflow (depreciation) and the inflow (new investment) (Banks and Tumlir, 1986).

Market failures in both labor and capital markets essentially reduces the mobility of factors of production. When the mobility of factors of production is reduced, adjustment to changing economic circumstances - at least in the short run - can lead to excessive costs. These costs arise in the form of disallocation cost measured by the amount of output sacrificed as labor and capital released from declining activities remain idle and in the form of adjustment costs measured in terms of the resources sacrificed to retrain labor, reorganize production operations and reorient the capital stock within the same firm, intra-sectorally or inter-sectorally (Richardson, 1980).

1.3 Market Failures due to Transaction Costs

Analyzing adjustment problems under conditions of market failures of the variety discussed above has been the main occupation of the literature addressing problems of adjustment to trade liberalization. Market failures in labor and capital markets - which mainly arise as a result of price rigidities - were the prime factors impeding instantaneous and frictionless adjustment. Notwithstanding the significant contribution towards understanding problems of adjustment, and although institutional factors were found to be responsible in many cases for imperfections in both labor and capital markets, the literature suffers from several caveats. Because the literature deals mostly with developed countries, the institutions of which are in general sound, the way in which institutions influence the path of adjustment did not receive adequate attention. In particular, one class of market failures those that arise -on lines of transaction cost theory- due to high transaction costs have been virtually neglected.

The main idea underlying the theory of transaction costs is that under the assumptions of asset specificity, bounded rationality and opportunism, the perfectly competitive model is no longer a realistic representation of the economic environment within which trade liberalization will take place. It is no longer realistic either to assume perfect foresight. The competitive model must essentially be replaced by the governance model. Adjustment within the framework of these imperfect market alternatives is neither instantaneous nor frictionless. (See Williamson, 1985; Klein, et al., 1978; Crocker and Masten, 1991). According to the theory of transaction cost, institutions influence equilibrium prices. In many respects prices are expected to deviate from competitive prices. For example, firms charge prices that are higher than competitive levels to safeguard investment in specific assets (Williamson, 1985) which can contribute to costly misallocation of resource (Klein, 1984).

In addition and as a necessary precaution against opportunism, price and quantity *rigidities* often characterize long term contract (Klein, et al., 1978). Prices can be also inflexible because asset specificity itself isolates the parties from other potentially profitable opportunities. No matter what is the mechanism adopted for price or quantity adjustment in long term contracts, the evidence is that adjustment tends to be either less than perfect - meaning that prices do not fully adjust to market prices or less than instantaneous - meaning that it takes time for adjustment to take place (Crocker and Masten, 1991). More seriously, were such rigidities are present, releasing investments to more efficient uses is constrained. (Masten and Crocker, 1985). In particular, the process of transferring released specific resources from inefficient to efficient activities will be hindered and consequently released resources are likely to stay idle. It follows that instantaneous and frictionless adjustment to free trade is not possible. The cost of adjustment will be higher the larger is the share of an economy's activity that is characterized by sunk cost.

To sum up, by now it should be clear to the reader what this discussion is principally concerned with. The main contention is that invoking the assumptions of asset specificity, bounded rationality and opportunism renders deviations from the neoclassical ideal referred to earlier more pronounced. Putting faith in the notion of instantaneous and frictionless adjustment to disturbances - of any nature - becomes harder than ever. In contrast to the traditional types of market failures previously analyzed were there is considerable scope to correct, improve the conditions or remove the distortions responsible for undermining the working of the market

mechanism, the high transaction costs of market contracting will continue to block the formation of markets and constraint the ability of the market mechanism to allocate resources efficiently so long as asset specificity remains as one of the common if not essential features of economic activity, bounded rationality and opportunism as salient characteristics of human nature as we know it and imperfect market outcomes as the only viable alternatives.

Section II

The analysis conducted in section one proves that an economic environment characterized by well functioning markets and well developed institutions is an important prerequisite for the efficiency and sustainability of the adjustment path to trade liberalization. As Egypt moves further towards integrating its economy in world markets, further reduction in tariff rates are expected to take place, it is thus necessary to examine the nature of the economic environment and how it conforms with or deviates from the ideal model sketched in the preceding section. The pertinent question is whether markets work well or not. It is also necessary to examine the extent to which the macroeconomic environment is consistent with the objectives of trade liberalization. The First task is taken up in this section.

Egypt's experience with free markets is quite new. Before 1974, and for roughly a decade and a half, an economic system based on central planning prevailed. During this period, a massive wave of nationalization of domestic and foreign private enterprises laid the ground for the creation and growth of a large public sector. Prices of numerous products in addition to key macroeconomic variables like interest rates and exchange rates were administratively set. A program of guaranteed employment for university graduates by the government and a policy of credit rationing implied that labor and capital resources were largely administratively allocated.

With the initiation of the Open Door Policy in 1974, a development strategy based on free markets was instituted. Although the Open Door Policy clearly assigned the leading role in the development process for the private sector, the public sector nonetheless continued to play the dominant role. Moreover, prices as well as resource allocation remained to be administratively determined through out 1974-1986. This policy was gradually abandoned under Egypt's structural adjustment program which was implemented following the slowing down of economic growth starting the eighties and the rising foreign indebtedness.

However, lacking competition is considered one of the striking features of domestic markets in Egypt. This explains to a great extent why the liberalization of prices which took place since the mid eighties (a number of commodities are still subject to government control including utilities, public transportation, pharmaceuticals, cotton and cotton products, water, bread, sugar and certain rationed goods) had no significant impact on competition. Apart from the agricultural sector, the only sector that can be characterized as relatively competitive is food processing while other product markets are characterized by duopolistic or oligopolistic structures where prices of imports inclusive of tariff provide a ceiling on price setting (USAID, 1995).

With the virtual absence of competition laws¹, complaints of anticompetitive practices are widespread mostly in retail distribution, cement, steel and food. There are no means to control or monitor the effect of the increasing number of cases of mergers and acquisition on market structure, unfair competition or the dominant position enjoyed by some firms (Hillal, 2002). Moreover in the absence of competition law, privatization would merely result in the transfer of rents from the government to the private monopolist with little impact on prices and quality (Ghoneim, 2002). Another major factor responsible for the lacking competition in domestic markets is the presence of barriers to entry and exit imposed by the regulatory and institutional framework.

2.1 Barriers to entry and exit

2.1.1 The Investment Regime

To encourage - domestic and foreign private sector participation in economic activity, generous investment incentive legislation has been introduced since 1973, comprised of a number of laws - Law 43 of 1974, Law 159 of 1981, Law 230 of 1989. These three laws differed according to the type of legal status, foreign versus domestic equity participation, areas of economic activity covered, tax exemptions, etc (see appendix for details). This incentive package has succeeded in attracting a considerable volume of private investment both domestic and foreign albeit with little impact on competition and with meager export performance. Foreign investment was mainly attracted to petroleum, banking and tourism while its contribution in the manufacturing sector was modest and concentrated in the area of luxury consumer products. The

¹ Egypt is currently drafting a new Competition law.

domestic private sector increased its share across all sectors of economic activity the largest of which went to the non-tradable sectors. Although the private sector penetrated areas previously monopolized by the public sector, the investment regime has had little impact on domestic competition due, in part, to the presence of a rigid system of investment licensing (abolished in 1991). According to this system, which was also characterized by excessive red tape, a license would not be granted to a project if the domestic market is already adequately covered by existing domestic producers unless it is export oriented (Handoussa, 1993).

Meanwhile entry continues to be deterred because of the excessively high capitalization requirements, especially deterrent of small enterprises (Goans, J., 2002). In 1997, Law 8 which granted foreign investment - for the first time - national treatment was introduced. However, local content requirement remained an obstacle to investment. Although local content requirement has been abolished in accordance with the Trade Related Investment Measures (TRIM) agreement, to qualify for custom exemptions, local content requirements are set as high as 60% for some industries (United Nations, 1999).

2.1.2 Imperfect Labor Markets

Domestic competition was further inhibited by a number of legal, regulatory and institutional factors that acted as strong barriers to entry and exit. Among the most important of these barriers are those imposed by labor laws.

Until the initiation of law 12 in 2003, the principal labor law governing employer/employee relationship in Egypt was Law 137 of 1981. According to this law the hiring or dismissal of employees under permanent contracts by firm must take place through the Ministry of Man power. For this same category of employees, the firm must abide by social security laws. Dismissal is subject to very stringent and cumbersome administrative procedures. Only upon the approval of a stoppage committee formed by a Ministerial decree, are firms allowed to alter their labor force. Contractual obligations of the firms remain in effect even under conditions of liquidation or bankruptcy (in the latter case as long court as appointed trustees are able to run the firm contractual obligations remain binding and only when the court approves asset liquidation of a bankrupt firm can employment contracts be terminated) until the stoppage committee finalize it's decision. In cases of temporary closures, only due to factors outside the employer's control, as concluded by the committee who will then decide if whether workers will

be paid full or half wages until work is resumed again. Again only for reasons completely outside the control of employers (natural disasters, wars, etc.) are final closures and thus termination of contracts- becomes possible. Finally, minimum wage legislation exists varying by industry, occupation and region and they are frequently adjusted for the cost of living (Assad, 1993).

Law 137 of 1981 has had quite a different impact on private versus public sector and formal private versus informal private sector. Establishments belonging to the informal private sector which accounts for 30% of total employment outside agriculture (establishments with less than ten employees), are generally not required to abide by the labor law. For the formal private sector, hiring on the basis of temporary contracts was the most commonly used method for circumventing this law whereby only 15-20% of formal private sector outside agriculture are covered by permanent contracts. In contrast there is no scope to circumvent the labor law in the case of the public sector where employment -except for construction- takes place only under permanent contracts. While employment under temporary contracts have reduced incentives for private firms to invest in training for sector specific skills, permanent employment contacts for the public sector have reduced its ability to adjust the size of its labor force in the face of changing economic conditions (Assad, 1993). Introducing new technology to restore competitiveness is obstructed due to costly dismissal procedures. Labor regulations have been also responsible for the increasing capital intensity in the private sector (Fawzy, 1999).

A number of health, environmental and safety regulations are also imposed by the labor law. The cost of abiding by the law for larger firms increases further if one takes into account the cost of training employees (which as mentioned above many firms are hesitant to undertake since the possibility that these trained employees would leave the firm remains open) given that support services for technical, vocational and administrative training is lacking for Egypt's Labor force, half of which is illiterate. All the above factors, particularly those pertaining to labor law contributes to the existence of large *sunk costs* that impedes both the entry and exit of firms. In general, this has rendered markets in Egypt non-contestable and comprised a form of protection enjoyed by existing firms as opposed to new entrants (World Bank, 1994).

With regards to all the points mentioned above, the new labor law, Law 12 of 2003, differs from Law 137 of 1981 in only one respect and that is related to final closures. The need

for a stoppage committee to approve termination of labor contracts or downsizing of the labor force is absent from the law.

2.1.3 Merger and Bankruptcy

Several other factors act as barriers to efficient exit. These include as discussed above labor regulations in addition to a legally complex merger and bankruptcy procedures. For example, the firm cannot take a decision -sell, merge, and change the product mix- which might involve a change in the size of its labor force without the approval of the stoppage committee (until 2003) (World Bank, 1992).

The bankruptcy Law² is too strict in terms of the sanctions imposed in the wake of insolvency. Debtors will be expelled from the commercial register, are deprived from the right to do business or occupy certain jobs. “Debt discharge” is not allowed even after liquidation and creditors receive their share of liquidated assets. Rehabilitation is not possible unless debt is repaid or after three years from the ending date of bankruptcy. For these reasons, debtors will avoid or delay adjudication as bankrupt, retard the process of administration of assets that follows bankruptcy or avoid exiting in general (Nathan Associates, 1998).

Some provisions - like partial discharge of debt - necessary for allowing debtors to continue in business and reorganize or restructure the firm while under the protection of the bankruptcy court are absent from the law. Troubled, but potentially viable firms are thus forced to exit. Lengthy, complicated and costly liquidation procedures due to the lack of special bankruptcy rules as well as specialized courts prevents the prompt reallocation of both physical and labor assets of an inefficient bankrupt firms to higher uses. As such, the bankruptcy law discourages entrepreneurship by increasing the risks associated with doing business and retards the efficient reallocation of resources (Nathan Associates, 1998).

Due to the inefficiency of the judicial system in Egypt, creditors often prefer out of court settlement rather than going through bankruptcy procedures. Out of court settlement is usually preferred also since labor debt has a priority over creditors’ debt and without the final approval of the stoppage committee wages to labor must continue to be paid thus reducing the prospects of any debt repayment (World Bank, 1992). Using the threat of filing a petition in bankruptcy, only the most insistent and aggressive creditors will be repaid their debt. In the meantime, the debtor

² Egypt is currently drafting a new bankruptcy law.

becomes more insolvent. Reorganization becomes more difficult and resources continue to be trapped in inefficient firms that are consistently trying to avoid adjudication as bankrupt and exiting (Nathan Associates, 1998). When the cost of exiting is high, firms avoid investment in industries subject to rapid changes in demand, technologies and short product cycles since the risk involved is considerably high (World Bank, 1992).

Both the investment regime and the regulatory framework within which the private sector was - and still is - operating had important repercussions not only on the type of activities favored by the private sector but also on the size structure of establishments. The private sector in Egypt is dominated by small scale enterprises (firms with less than ten employees) which accounted for 98.3% of establishments of the private sector and accounted for 77.3% of the total employment in 1996 (Handoussa, 2002). Its early flourish goes back to the 1960 where small size informal private enterprises were the only means of survival during an era of nationalization and central planning. With the liberalization of 1975 several factors have helped reinforce this structure (World Bank, 1994).

First: The investment incentive package introduced was primarily designed to benefit medium to large scale projects. For example, licensing approval - before 1991 - was contingent on the use of serviced land located in new urban cities where full ownership is first set on probational basis and is denied if the project is not set within three years. In the outset, this has meant that land cannot be used as collateral. Moreover, the cost of registration fees for land is very high equal to 12% of its assessed value. (Law 6/1991 gave a temporary 50% reduction in those fees for land registered through 1994.) These high fees are sizable costs to cash constraint small scale enterprises. *Second*, the private sector regulatory framework has inhibited the growth of small scale enterprises to medium or larger scale. To mention but a few, the high cost of abiding by the regulations imposed by labor laws can only be avoided by small size.

Third: Again because of the weak state of the judicial system, banks over collateralize to secure their debt and thus most of bank lending is directed towards medium to large enterprises and is mainly of short run maturity (five years).

Fourth: A very restrictive legal framework for securitization impairs the ability of firms in general and small scale enterprises and new firms - that lack any credit history - in particular to mobilize lending.

As mentioned before, barriers to exit and entry is one important factor responsible for the lacking competition in domestic markets. The effect of lacking competition was reflected in the high prices and poor quality of most goods and services produced in Egypt. One area where this is evident is in the services sector (financial intermediation, insurance, business services, telecommunications, transportation etc.). For firms, the cost of the poor quality of services corresponds to an implicit tax estimated to be equivalent to 15% tariff. Because of the importance of services inputs in a wide range of industrial activity, this implicit tax has substantially reduced the effective protection they enjoyed (Hoekman, 1997).

Barriers to exit, entry or alter size reduces the degree of “dynamism” in the economy (ECC, 1988). Firms that are small in size are unable to and do not have any incentive to expand which implies that markets provide little if no scope to benefit from economies of scale, while firms that have to downsize in order to be able to compete or restructure are constrained from doing so. Low dynamism ultimately reduces the speed of adjustment of the economy in response to changing economic conditions and impedes the release of resources out of inefficient activities to more higher uses.

2.2 Market Failures due to Transaction Costs

Adjustment problems will be further accentuated due to the condition of asset specificity which serves as an important barrier to exit and entry and a leading cause of market failures as highlighted in section one. This is true to the extent that the share of the economy’s activities that is characterized by sunk costs is large and to the extent that other aspects of the regulatory and institutional environment impose high transaction costs on those who engage in economic activity.

To begin with, it must be noted that court jurisdiction in Egypt is extremely inefficacious and business surveys have proved that it is one of the most binding constraints facing private investors. Resolving disputes is very costly in terms of time and resources. It usually takes around four years on average to settle disputes compared to one year outside courts. Contract and law enforcement in general is very weak. Expropriation risk is high. The current legislation - inherited from the central planning era - which is also more suited to a closed economy is deemed incompatible with an opened market economy (Fawzy, 1999). Transaction costs arise because laws are complex, procedural requirements are enormous and the system itself rests

fundamentally on the premise that the government is responsible for assuring “propriety” of any action. In general, such characteristics have only served reinforce government control over business activity (Joans, 2002) and thwart the forces of competition.

Property rights are not well defined. Some of the articles in the constitution asserting collective ownership of means of production continue to exist (Hillal, 2002). Although Egypt is a signatory to the main international patents, trademarks and copyrights convention, violation of copyright laws especially in the areas of video and audiocassette and disks, medical textbooks and computer software is considered a major problem for business involved in these activities. As a result Egypt has been on the United States ‘watch list’ and ‘priority watch list’ which pertains to countries that does not provide adequate intellectual property protection according to Section 301 of the United States Trade Act of 1988. The problem is less severe in cases of protection of trademarks and industrial designs and models but law enforcement is rather weak as courts have little experience in dealing with infringement cases. The lack of supporting infrastructure and the weakness of the judicial system acts as a strong barrier to investment in research and development and inhibits innovation. It is not surprising then that expenditure on research and development by both private and public sectors in Egypt is below the benchmark 1% of GDP set for developing countries (United Nations, 1999).

The environment is highly uncertain, a feature that is ranked by investors as another important binding constraint to doing business in Egypt. Inconsistent policies are frequently initiated. Policy reversal is very common since there are no national (law, constitution) or international restraints (foreign aid that is tied to economic rather than political conditions, strong commitment under the GATT/WTO, etc.) to prevent such reversals (Galal, 1996).

The institutional environment exemplifies most of the features that discourages investment in specific assets; high uncertainty, weak property right and law enforcement in addition to a letter of law that is too strict (labor law, bankruptcy law) (Williamson, 1991) all of which could be taken as indications that asset specificity is not so important in the Egyptian economy. While there is preliminary crude evidence that in the case of the private sector both human and physical asset specificity is not significant given the small informal nature of establishments, it is not clear whether this is true in the case of the public sector which continues to account for the major share of economic activity. However, even if asset specificity is not

significant, by its very nature, public ownership implies that the high powered incentives of the market are totally suppressed, a major factor that reduces the speed of adjustment to free trade. Meanwhile, and as mentioned earlier, an institutional environment with the above undesirable characteristics rules out revitalization as a viable adjustment strategy whenever it is necessary to invest in specific asset.

Several other aspects of the institutional and regulatory environment are responsible for high transaction costs. To mention but a few, firms incur these costs from the very first minute a decision is made to enter the business to the very last minute until - if conditions dictate so - it exits the market. During the course of its activities, transaction costs are incurred as tax obligations are met, as inputs that cannot be procured domestically are imported and as part or all of its output is exported.

Forming a new enterprise is subject to lengthy and costly procedural requirements (Joans, 2002). Exiting involves considerable transaction costs primarily because those who are responsible for administering liquidation receive fees that is deducted from the value of liquidated assets, the size of which increase as this process lasts longer, creating strong incentives for costly delays and reducing the amount creditors can ultimately receive (Nathan Associates, 1998).

Tax administration³ in Egypt is highly inefficient. The existing relationship or contract - between the tax authority and tax payers - results in great uncertainty, discretion, disputes and negotiations thus increasing the transaction costs for both parties. High transaction costs mainly arise because of the importance of private information, moral hazard and adverse selection. Both the tax payer and tax collectors are able to exercise opportunism because they have private information that they can conceal from one another. Tax payers have information on their costs, revenue, records etc and thus are in a position to exercise precontractual opportunism. Tax collectors private information stems from their granted discretionary power in interpreting and implementing the law. Bonuses and incentives to tax collectors are also private information that is not available to tax payers and strongly influences the estimates of tax obligations all of which makes them well positioned to exercise postcontractual opportunism (Tohamy, 1999).

³ Egypt has drafted in 2005 a new tax law but has not been executed yet, whether this new tax law will overcome the inefficiencies described above remains to be seen.

Problems of moral hazard occur if it is costly or difficult to detect a change in behavior taking place in response to a change in the law or any other regulation, but is rendered economically inefficient or not in compliance with the new law or regulation. Under these circumstances law enforcement becomes almost impossible. For example, to avoid large tax liabilities, in the event tax collectors revise profit figures upward, tax payers tend to under report their profits decreasing - in turn - potential tax revenue. On the other hand, due to the discretionary power that tax collectors seldom have to overlook or ignore the records, sizable unofficial side payments can be extracted in return for lower tax liabilities. Tax payers also happen to resort to court settlement in situations where this is unduly needed, a behavior that cannot in practice be sanctioned and therefore prevented (Tohamy, 1999).

The complexity, the lack of transparency, wide spread corruption and inefficiency of the dispute settlement mechanism etc. for tax collection lead to problems of adverse selection whereby some groups are discouraged from engaging in economic activity while encouraging those that are most likely to reduce efficiency. These are among the main factors discouraging foreign investment and increasing the number of small scale enterprises that prefer to operate within the framework of the informal sector. Moreover, corrupt tax collectors - those most likely to lobby for unofficial side payments - will compete to locate in industrial areas where the prospects of such illegal payments are wider crowding out - in this process - honest tax collectors specially in those areas where such lobbying will have the greatest negative repercussions (Tohamy, 1999).

Problems arising in the implementation of tax laws are typical with most other laws. The perceptions of the business community is that even when the right laws are enacted there are usually problems with implementation and enforceability. For example, there is considerable lag between the enactment of laws and the issuing of executive decrees. This leads to ample room for discretion by the implementers and consequently led to high transaction costs. Besides, there is lack of qualified personnel for implementation. This causes problems especially when laws are vague or contradictory (Ghoneim, 2002).

Trading⁴ involves substantial transaction costs mainly due to administrative red tape.

⁴ Egypt is drafting a new custom law and the authorities are trying to simplify custom clearance procedures, but the outcome is still to be seen.

Strikingly enough, administrative red tape have rendered the major incentive introduced to offset the anti-export bias of the trade regime - the temporary admission and drawback mechanism-ineffective. Besides the limited scope of benefiting from these incentives in terms of eligibility (when first introduced they were not extended to indirect exporters and remains to be granted only if the local content of the final product is 20% while non sale indirect taxes cannot be refunded) they are characterized by administratively cumbersome procedures. The resulting transaction cost along with other forms of existing administrative barriers to exporting is estimated to account for 10-15% of the export price. Importing activities share similar burdens. These include low quality/high cost port services - raising the CIF cost of imports by over 10% - and cumbersome import clearance procedures equivalent to a tariff of 15% (World Bank, 1997a).

2.3 Macroeconomic Conditions: The Implications for Adjustment

At this point, the answer to the question posed in the beginning of this section can now be safely asserted to be negative; given the above evidence markets in Egypt *do not* seem to work well. This is true for product, labor and capital market. Market failures arise because of the presence of barriers to entry and exit, price rigidities and high transaction costs. Instantaneous and frictionless adjustment to trade liberalization is impossible. Whether the prevailing macroeconomic conditions will provide more evidence in support of this last result is an issue that remains to be examined and will be undertaken in the next section.

Section III: Macroeconomic Conditions

In the analysis of the adjustment costs to trade liberalization, it is natural to expect that macroeconomic conditions influence the adjustment path. After all, adjustment costs are ultimately manifested in falling output, rising unemployment and increasing pressure on the balance of payment all which are macroeconomic variables.

Besides favorable initial conditions on account of these three variables, macroeconomic conditions conducive to minimum adjustment costs encompass all conditions or policies that promote economic growth. Only then can expanding efficient import substituting and export industries absorb resources released from inefficient activities, the incidence of transitional unemployment be reduced and pressure on the balance of payment be relieved (World Bank, 1991). In what follows developments in some of the macroeconomic variables and policies that are important in this regard will be analyzed.

3.1 Real exchange rate appreciation

Since the exchange rate unification in 1991 Egypt has adopted a managed float regime with the nominal exchange rate pegged to the US dollar. This rate has remained stable over a fairly long period of time thus eliminating exchange rate risk (Abdel Khalik, 1995). The success of the economic reform program in achieving both fiscal and monetary stringency with the subsequent reduction in the rate of inflation from 20-30% in the late 80's to 7% in 1997 in addition to the debt relief made by the Paris club have restored investment confidence. The government privatization of state owned enterprises together with the persistence of substantial interest rate differential between foreign and domestic interest rates have revived foreign interests in Egypt's capital markets inviting massive short run capital inflows. In 1996, these foreign interests represented 30% of the turnover in Cairo stock markets and portfolio flows reached \$500 million (World Bank, 1997).

To maintain a fixed nominal exchange rate the Central Bank intervenes by buying US dollars for Egyptian pound with the government partially sterilizing the expansionary effects on the money supply through issuing treasury bills (Abdel Khalek, 1995?). Despite sterilization, the inflationary effect of the increase in the money supply translated into an appreciation in the real exchange rate *against US dollar* by roughly 33.05 % throughout the period 1991-1997.⁶

However, the declining rate of inflation and evidence of increased inventory suggests that the real appreciation of the Egyptian pound against the dollar does not result from increased spending by foreigners but rather can be explained by what is taking place in asset market. This has been the primary reason why the authorities have resisted this upward pressure through sterilization (World Bank, 1997). Sterilization -which ceased late 1993- through issuing treasury bills well above the government borrowing requirement have preserved the spread between foreign and domestic interest rates reinforcing capital inflows (World Bank, 1994). Over the interval 1991-2002, the real exchange rate appreciated by approximately 16.36% against the US dollar.

²The real exchange rate is equal to the nominal exchange rate multiplied by index of foreign prices divided by index of domestic prices.

Between 1991 and 1989, a 40% appreciation of the export weighted real exchange rate - against a basket of currencies of major competitors in export markets also took place of which 9% is due to inflation differentials between Egypt and its major trading partners and the remaining 31% due to the increase in the value of the dollar relative to other currencies (Kheir ElDin and El Shawarby, 2002). Real exchange rate appreciation has been one of the main reasons behind the concentration of private investment -at least medium to large enterprises- in the non-tradable sectors (World Bank, 1997) and continues to discourage production for exports.

Since 2001, Egypt has moved from a fixed exchange rate regime to a more flexible one in which periodic adjustment to the official rate will take place whenever market forces - as envisaged by the central bank - dictate so (Bennet, 2002). The nominal exchange rate has since then dropped to 6.2 LE/\$ in 2003.

3.2 Monetary and Fiscal policies

One of the main goals of the reform efforts since mid-eighties was achieving monetary and fiscal stringency in order to reduce the rate of inflation. Since then a considerable decrease in the rate of growth of monetary aggregates took place. Annual rates of growth in the money supply M1 (excluding demand deposits in foreign currencies) declined from 7.21% in 1986 to (-4.03%) in 1991, showing positive and increasing rates of growth afterwards, but declining to -6.71% by 2000 and further to 5.6% in 2003. The annual rate of growth in domestic credit decreased from 18.77% in 1986 to 7.89% in 1991 and increased to 13.3% in 2003. Lending interest rates increased from 15 % in 1986 to 20.3% in 1992 and decreased to 13.5 % in 2003.

The annual rate of growth of the money supply was curtailed as the budget deficit - and thus its monetization - fell dramatically from (-5,494) million LE in 1990 to a surplus of 1828 million LE in 1995. Meanwhile the rate of inflation (measured as percentage change in the consumer price index at 2000 prices) fell from 12% in 1993 to 4.2% in 2003. (It must be noted however that the rate of inflation depends on the nature of the basket of goods chosen to calculate index prices.)

3.3 Aggregate demand

Aggregate demand including imports for goods and services (in constant 1995 prices) exemplified negative or modest rates of growth through out much of the period 1986-1999. These rates have varied between (-0.07) in 1986 to (0.01) in 1991 and 6.3% in 2003. Wide

spread excess capacity in the industrial sector signals insufficient demand as one of the main factors influencing capacity utilization. The rate of growth in real government consumption (in constant 1995 prices) increased from (-0.08%) in 1986 to 5.7% in 2003. Gross fixed capital formation (in constant 1995 prices) grew at an annual rate of (-0.01%) in 1986 and falling by 3.1% in 2003. Real private consumption (in constant 1995 prices) - which accounts for the major share of aggregate demand - grew at an annual rate of (-0.05%) in 1986, increased to 4.2% in 2003. At the same time the annual rate of growth in exports of goods and services (in constant 1995 prices) have registered negative rates in a number of years between 1986 and 2002 increasing from (-0.26%) in 1986 to 0.06% in 2002, and further by 24.3% in 2003. Given that the bulk of merchandise exports consist of crude or refined petroleum it is difficult to foresee any revival of aggregate demand based on manufactured exports especially in light of the developments taking place in Egypt's major export markets.

3.4 The external sector

Among the many positive achievements of the Uruguay round negotiations completed in 1993 was a significant reduction in both tariff and non-tariff barriers of developed countries. While this will increase market access to developing countries it also means that those countries that enjoyed preferential treatment of one form or another will be facing fiercer competition. This is especially true for Egypt where the bulk of its exports enjoy special treatment under the Most Favored Nation (MFN) tariffs - which faces an average reduction of 40% - or the Generalized System of Preferences (GSP). Egypt receives preferential access on 65% of (non-zero) lines exported to Japan and 45% on lines exported to the United States (Yeats, 1998).

Egypt enjoys preferential access to the EU market according to the association agreement between Egypt and the EU – Egypt's major trading partner -, but faces significant non-tariff barriers on its agriculture exports. Also, stringent rules of origins act as a powerful constraint on Egypt's exports to the EU market.

The average of 40% reduction in developing countries tariff rates on manufactured goods is likely to produce minor gains for Egypt due to the below average cuts (19-25%) on leather, textile and clothing. As for non trade barriers, the phasing out of the Multi fiber agreement (MFA) would increase market access though under tougher competitive conditions. On average the ratio of Egyptian exports facing non-tariff barriers will drop from 32% to approximately 2%.

In 1992, only 17.6 % of exports destined to the United States and 13.2% to the European Union face non-trade barriers (Yeats, 1998).

3.5 Current Account

The situation on the balance of payment front is not all the more promising either. Trade deficits continued to ensue throughout the period 1980-1996 increasing from (\$5215) million in 1985 to (\$5747) million in 2002 falling slightly to \$4201 million in 2003. Over the entire 80's decade the current account balance showed a deficit and turned from a surplus of (\$185) million in 1990 to a deficit of (\$971) million in 2000 and turning to a surplus of (\$3743) million in 2003. The overall balance showed a deficit over much of the period 1980-2002. In 2003, the overall balance registered a deficit of (\$407) million.

3.6 Macroeconomic conditions: the implication for adjustment

The above figures provide clear evidence of a macroeconomic environment that is basically recessionary. Empirical analysis identifies a recessionary environment (weak domestic and external demand) as one of the most important factors contributing to the presence of high adjustment costs to trade liberalization (World Bank, 1991). Under such circumstances it is hard to expect that trade liberalization will have a significant impact on investment allocation and consequently on growth especially in the absence of any measures- as is the case- to promote exports and as the phenomenon of real exchange rate appreciation continues to persist.

Contraction in those sectors adversely affected by competition from imports will not be counteracted by expansion in the more competitive sectors. As a result, released resources are very likely to remain idle. Furthermore, a sluggish supply response is very likely to aggravate pressure on the balance of payment and jeopardize the sustainability of all efforts to liberalize trade. In general, and since the very first attempt to liberalize trade in 1986, the macroeconomic environment has not been consistent with the objectives of trade liberalization.

In general, an economic environment hampered by market failures and plagued by inefficiencies certainly raises concerns about the costs of adjustment to trade liberalization. However, the correct policy response is not to abandon liberalization all together but to carefully plan the correct timing and choose the path of tariff liberalization along with the set of adjustment policies that minimizes the magnitude of any adjustment costs.

What is important to recognize at this stage is that there will be little if no gains from trade liberalization as long as the economic institutions of capitalism remain underdeveloped. Reform on both the microeconomic and macroeconomic level is needed. In this regard, removing the institutional sources of market imperfections in the labor market like minimum wage legislation is necessary. Stringent hiring and firing procedures must be simplified. The bankruptcy law must be modified along the lines of laws prevalent in developed countries so as to facilitate exit. Capitalization requirement has to be reduced to encourage entry by small scale enterprises. In the mean time, competition law must be put in place. One way to deal with imperfections in the capital market arising due to collateral requirements is through the government providing credit guarantees to firms that cannot tap capital markets.

Reform of judicial system is indispensable. Tax administration has to be improved and the law itself should be modified to lessen the extent of exercising opportunism by both tax collector and tax payer. In particular, the law must be clear and transparent so as to substantially reduce the discretionary power enjoyed by the executers. Here also the experience of developed countries should be useful. The same remark holds true for the customs law. What is needed in this regards is a set of executive regulations to accompany the law.

The most important macroeconomic area of reform is exchange rate policy. Egypt should adopt a flexible exchange rate system so that the exchange rate reflects the true scarcity of foreign currency. Any devaluation occurring will automatically help relieve pressure on the balance of payment by making imports expensive and exports cheaper. This will make up for any reduction in tariffs following liberalization and will consequently provide the necessary protection for efficient import substituting industries. At the same time, this policy will enhance expansion in the export sector. Nevertheless, to prevent any overvaluation of the currency due to capital inflows, the Central Bank should interfere by buying dollars when necessary.

It remains to discuss the relevance of Egypt's reform experience to other developing countries. What is so obvious about this experience is the absence of a *comprehensive* vision for reform. For example Egypt launched institutional reform a decade and a half after adopting the World Bank and IMF structural adjustment and stabilization package in 1991 and only when its negative repercussions on growth and resource allocation were hard to ignore. Passing new laws is not, however, the end of the story. Resistance by those who benefited from complicated laws –

the civil servants- through side payments and bribes have proved to be strong. Reform of the civil service should have accompanied and perhaps preceded institutional reform. So far it is not clear how the government intends to deal with this problem. To conclude, the overriding impression of Egypt's experience is that reform on many fronts came late, was incomplete and slow. This breeds an economic environment that is likely to give rise to high adjustment costs to trade liberalization.

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Appendix

In 1973, the major investment policy stimulus was the introduction of a generous investment incentive package that applied for foreign as well as domestic private investors and consisted of the following components: (Handoussa, 1993).

1-Law 43 of 1974: Applying to all fields of economic activity except petroleum, law 43 differentiated between two types of projects inland projects and free zone projects. Inland projects required Egyptian equity participation-unless exemption is stated- though no specified minimum is stipulated. These projects can enjoy tax holidays on profits for five years, increasing to eight years if the project engaged in high priority activities e.g., export oriented projects and further increasing to ten to fifteen years for projects in land reclamation and new cities. Projects also enjoyed exemptions from tariffs on capital goods and labor laws. No licenses for importing or exporting were required and projects were not subject to any forms of price controls. By 1977 the law was amended eliminating foreign exchange control regulations allowing firms to buy their foreign exchange requirements on the domestic market and the full repatriation of capital and profits. As for free zone projects, no Egyptian participation was required and beside exemption from custom duties they enjoyed unlimited tax holidays. These projects are allowed to sell their products in the local market and are not subject to any restrictions to repatriate profits from exports. They are required to pay rental fees and are subject to a 2% tax on value added. Under this law foreign ownership of land was not allowed and workers participation in profits was at discretion of the company. In 1977 amendment 32 to law 43 required projects to distribute 10% of profits to workers.

2-Law 159 of 1981 (The Company law): originally replacing the old company law 26 of 1954, law 159 covers joint stock, limited partnership and limited liability companies in all areas of economic activity. This law required a minimum of 49% Egyptian participation in equity. The privileges of law 159 can be extended to foreign joint ventures provided foreign share in equity is not more than 51%. Shares listed on the stock exchange enjoyed 50% tax exemption while projects established in new cities enjoyed the tax advantages of law 59 of 1977. In contrast to law 43, law 159 of 1981 does not provide any custom exemptions and projects are subject to exchange controls as well as import and export licensing. Price control is also possible. Capital

and profits cannot be repatriated and 10% of profits -with a ceiling of one year's wages- is to be distributed to workers. Upon the introduction of this law the number of joint stock companies increased from 27 in 1960 to 400 in 1992.

3-Law 230 of 1989: pertained to all areas of economic activity excluding finance, contracting consultancy and transport. Egyptian participation in equity is not required. Tax holidays increased to 5-10 years, 0-15 years for high priority projects and 15-20 on low cost housing. The law does not allow custom exemptions. No licenses for importing or exporting were required and projects were not subject to any forms of price controls. Projects are allowed to repatriate capital and profits and are not subject to any foreign exchange control. Foreign ownership of land is permitted and 10% of profits must be distributed to workers.

4-Law 8 of 1997: For the first time foreign investment is granted national treatment. Applies for 18 activities (land reclamation; fishing, poultry and animal production; industry and mining; tourism covering hotels, motels tourist villages, tourist transportation; maritime transportation; refrigerated transportation; and related services, air transportation and related services, housing; real estate development; oil production and related services; hospitals and medical centers that offer 10% of their services free of charge; water pumping stations, electricity, roads and communications; venture capital; computer software production; projects financed by the Social Fund for Development; leasing; risk capital and guarantees for subscription in securities; petroleum refining and cinema production. All companies listed under this law can in principal own land and building as necessary for business operation irrespective of the level of foreign ownership (United Nations, 1999).

Starting from the first year of operation and for a period of 5 years the law exempts profits from the Tax on the Revenues of Commercial and Industrial Activities and the Tax on Stock Companies Profits for a period of 5 years. The tax exemption extends to 10 years for firms located in new industrial zones, new urban communities as well as in remote areas. For activities located outside the Old Valley, the tax exemption period extends to 20 years. Projects also enjoy tax exemptions on part of paid-in capital (to be determined by the Central Bank) and on returns on securities issued by projects listed on the stock exchange. Merged companies continue to benefit from tax exemptions that were previously granted to any one company before the merger. As for imports, projects are free to import machinery, components and means of transportation

needed. Imports of machinery is subject to a flat 5% rate. Projects are not subject to any control regarding prices or profits (United Nations, 1999).

In all of the laws described above, after the period of tax exemption ends, companies are subject to the corporate income tax. The standard rates stand at 40% and falls to 32% for industrial and export activities. However after allowing for very generous deductions in calculating taxable income the effective tax rate drops to around 25.29% and is considered one of the lowest by international standards (Ministry of Economy, 1996).

Law 8 of 1997 conforms with provisions of law 230 of 1989 with regards to free zones. In principal the law allows all kinds of investment in free zones. In special cases where existing free zones are considered impractical, the General Authority for Investment (GAFI) can establish a factory site (no longer for warehousing) a free zone. In addition, upon approval of the GAFI, sites of already existing factories can be converted into private fee zones. This is based on the condition that at least 50% of output of these factories should be exported. Goods produced in Free zones are not subject to custom duties, or any other kind of tax. (Imports from free zones and into the country are subject to import duties. In addition, laws that govern maritime trade and the registration of merchant vessels do not apply for maritime transport projects and ships operating in free zones. Besides establishing free zones, other incentive measures introduced has been the “technology valleys” program with the prime objective of developing new zones with specially equipped infrastructure suitable for investment in high technology industries (United Nations, 1999).