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THE POLITICS OF INVESTMENT AND  
GROWTH IN EGYPT:  
TOWARDS A NEW APPROACH

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## Abstract

How can governments achieve substantial increases in productive private investment? 'Improve the investment climate' is the dominant advice. However, national-level investment climate approaches have been criticized for not giving adequate attention to context and feasibility. This paper experiments with an approach which addresses these concerns by focusing on sectors and on the relationships between policy makers and investors. After setting out a framework for using this approach, the paper then examines whether it can explain the considerable inter-sectoral and inter-temporal differences in investment in Egypt. The paper shows that where public-private relationships are based on common interest, obstacles to investment and growth are more likely to be removed. The risk of abuse of such public-private interaction is acknowledged but in the examined sectors they have been effective transitional arrangements for enhancing investment and growth and for inducing a new dynamic.

## ملخص

كيف يتثنى للحكومات عمل زيادة مستدامة في الاستثمارات الخاصة المنتجة؟ تحسين مناخ الاستثمار هي النصيحة الأهم. ومع ذلك، فقد تم توجيه النقد إلى مناهج مناخ الاستثمار على الصعيد الوطني وذلك لعدم إعطاء الاهتمام الكافي للبيئة والجدرى الاقتصادية. وتجرب هذه الورقة منهجا لمخاطبة هذه المخاوف بالتركيز على القطاعات والعلاقات بين صناعات السياسات والمستثمرين. وبعد تحديد إطاراً لإستخدام هذا المنهج، تبحث هذه الورقة فيما إن كانت تستطيع تفسير الاختلافات الكبيرة بين القطاعات وعلى مر الزمن بخصوص الاستثمار في مصر. تشير الورقة أنه حينما تركز العلاقات العامة والخاصة على المصلحة المشتركة، فإن يكون من المرجح إزالة العقبات التي تواجه الاستثمار والنمو. لقد تم الأخذ في الاعتبار خطر إساءة استعمال التفاعل العام والخاص ولكن في القطاعات التي تم دراستها كانت هناك ترتيبات انتقالية مهمة لتعزيز الاستثمار والنمو وإحداث ديناميكية جديدة.

## 1. Introduction<sup>1</sup>

It is now generally accepted that substantial reduction in poverty requires accelerating economic growth and that such growth requires increasing investment. Low levels of private sector productive investments appear to be a major obstacle to economic growth in developing countries. Even though this issue has received much attention in the academic debate in the last 40 years, the dynamics of private investment and growth remain enigmatic, and solutions for developing countries remain difficult to derive.

In the recent policy debate, these issues are discussed in terms of improving the investment climate. For example, the 2005 World Development Report ‘A Better Investment Climate for Everyone’ identifies a range of obstacles and ideas for moving forward. Many other policy documents have appeared concerned with improving the climate for business. At their core is the suggestion that improving the regulatory framework is essential for accelerating investment and growth. Particular attention is given to legal enforcement of property rights and contracts while reducing other regulations. A lot of effort has gone into developing indicators to measure the appropriateness of the regulations in place. The best known is the ‘Doing Business’ indicator (of the World Bank- IFC) which is used to provide benchmarks, compare countries and urge governments to reform regulations. With such quantification, it seems, attention to investment climate issues has further increased. International conferences and workshops around the world have been trying to take stock and derive lessons.

Criticisms of such investment climate approach fall roughly into two groups: first, there are those that concentrate on the measurement. They criticize the choice of indicators, the reliability of the data, and the uses to which it has been put (for example, Commander and Tinn, 2008 and IEG, 2008), or they argue that measurement is more effective if carried out at the sub-national level— the district or province (for example, VNCI, 2007).

The second group concentrates not on measurement but on dynamics and context, questioning the assumption that reforming regulations is the key to raising investment and generating growth. These critics are not against reforming regulations but against making it the all out focus for research and policy, suggesting that it is neither a necessary nor a sufficient condition for raising investment and generating growth (for example, Altenburg and Drachenfels, 2006; Khan, 2005 and 2008; Moore and Schmitz, 2008). What is necessary and appropriate is seen to depend on the circumstances. This view is expressed most clearly in the work of Rodrik and colleagues on growth strategies, which stresses that reform is contingent on the economic circumstances of the country and that the binding constraints differ from country to country (Rodrik, 2005 and Hausmann et al. 2007). This view has gained increasing acceptance but the question of how best to identify the binding constraints on investment remains wide open. Is this best done at the national or sectoral level?

This zooming in on the binding constraint has quite rightly attracted a lot of attention because it is not just about context specificity, but also about the feasibility of moving forward. There is an increasing recognition that it is not possible to do everything at once because the executive capacity of the state is limited. Investment climate reforms “often overtaxed extremely limited implementation capability” (Pritchett 2008: 17). Not surprisingly there is particular interest in small policy changes that have a big impact. This is fuelled by the recognition in studies on growth spurts that growth was sometimes ignited by adopting a limited range of measures (Pritchett and Rodrik, 2005). The idea of focusing on the binding constraints encapsulates this ambition to incorporate implementation feasibility issues into growth analysis and advice.

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<sup>1</sup> A previous draft of this paper was presented at the Middle East Economic Association Conference (MEEA) Nice, France, 18-20 March 2009 and generated very helpful comments.

Bringing these concerns with context specificity and implementation feasibility into growth analysis seems a big step forward. Driven by these concerns, Hausman et al. (2007) have developed ‘Growth Diagnostics’— an analytical framework for understanding and promoting growth at the national level. The relevant context is seen to be the country. The binding constraint is identified by working through a decision tree which structures the search process. This step-by-step process can take the following form: Starting with the problem of low investment, it asks if this problem is due to inadequate returns to investment, inadequate private appropriability of the returns, or inadequate access to finance? If it is a case of poor appropriability, is it due to market failures (externalities) or government failures? If it is the latter, is it due to high taxation, poor property rights and contract enforcement, and so on? This approach has been used in some countries and donor agencies are keen to try out on more. Meanwhile the authors stress that Growth Diagnostics is still at an experimental stage (Hausmann et al 2008; Pritchett, 2008). The spirit in which this experimentation is being conducted is captured well by Rodrik (quoted from Pritchett 2008: 18): “Reform discussions focus on the need to get away from “one-size-fits-all” strategies and on context-specific solutions. The emphasis is on the need for humility, for policy diversity, for selective and modest reforms, and for experimentation.”

The research presented here takes up precisely this challenge. It experiments with an approach which addresses the same question, namely detecting the key factors that make a difference to investment and growth. It is driven by the same concern with context specificity and implementation feasibility. Yet the approach is different in two respects: first, the need to be context specific leads us work at the sectoral rather than the country level. Second, the need to take into account implementation feasibility leads us to adopt a more political approach which centers on the relationships between policy makers and investors.

Let it be clear from the outset that the objective is not to launch a competitor to growth diagnostics. Far from it, as will be seen in the course of this paper, the approach adopted here has its limitations when it comes to moving from the micro to the macro. But it also has its strengths in that it helps to unravel key factors which trigger investment and can give rise to a new growth dynamic. In that sense it might be complementary to growth diagnostics, but it is too soon to address this issue. The objective of this paper is to introduce the approach, show its explanatory power, and bring out the limitations.

As mentioned, the approach is sectoral and political. The arguments for sector-level analysis of investment and growth have a long history (see for example, Shafer, 1997; Schmitz, 1982). The arguments fall into two groups. First, the variations in technology, capital requirements, marketing barriers, and business organization are enormous<sup>2</sup> and these differences matter for policy. Second, there are often wide variations in investment and growth between sectors even though they all operate in the same national policy environment. Egypt, the country on which we focus, is a good example. The hypothesis underlying this study is that a great deal can be learnt from examining these inter-sectoral differences.<sup>3</sup>

More controversial is the political element brought into the approach. Our reasoning is that if we are concerned with implementation feasibility we need to understand the relationships between policy makers and investors. This is not a new idea. Close state-business relations play a key role in explaining the successful East Asian growth strategies (for example, Amsden, 1989, and other studies reviewed by Evans, 1997 and Schneider, 1998). However, in analyses of other parts of the world, close state-business relationships are seen to be a source of problems and failure. The reasons are easy to see: such relationships can be abused

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<sup>2</sup> One could add that the mobility of capital and people between sectors is more limited than assumed in much economic analysis.

<sup>3</sup> There is little research capturing the inter-sectoral differences. Investment is typically studied at an aggregate level.

resulting in big private and few public gains. Examples of such abuse are not hard to find and the literature has used them to the full, so much so that the thinking on public-private alliances is dominated by concerns with corruption and rent seeking. The best known example is the Philippines under President Marcos (Hutchcroft, 1998) — widely seen as the embodiment of ‘crony capitalism’. Such experiences have been used to de-legitimize any close relationship between policy makers and investors.<sup>4</sup>

Neo-liberalism in particular eagerly embraced the negative experiences and the specter of rampant rent seeking making state-business relations a suspect topic in the development debate. This is now changing; there is a growing (but often grudging) recognition that for a government that seeks to foster economic growth it is neither realistic nor desirable to keep business at arm-length. The new constructive realism is visible in several research programs which are supported by DFID<sup>5</sup> and which examine the relevance of state-business relations for economic growth. For example, Sen and Te Velde (2009) suggest that state-business relations have a positive impact on economic growth in Africa, based on an analysis of the visible, institutionalized and formal relationships.

The more challenging question is whether such a positive influence comes from less visible relationships which are not (yet) institutionalized and work informally. It is well known that such relationships are pervasive but much less is known about how they affect investment and growth in contemporary developing countries.<sup>6</sup> This is where this study makes its main contribution, taking up the challenge put forward by Moore and Schmitz (2008) in ‘Idealism, Realism and the Investment Climate in Developing Countries’. They suggest that informal relationships between politicians/policy makers as holders of political power and investors as holders of economic power needs to be put centre stage in order to understand why investment and growth increase in adverse circumstances. They draw attention to enormous differences that can often be found within countries and ask how one can explain substantial investment and growth in particular industries and localities of countries that are thought to have poor investment climates at the national level. Did informal relationships play a role in bringing about this investment? What were the key features that made these relationships effective?

These precisely are the questions addressed in this paper which investigates the case of Egypt. For most of the last three decades, Egypt recorded declining rates of investment and growth. External advice on how to change this was not lacking. Egypt was at the receiving end of much donor advice on the investment climate and actually carried out some reforms to improve it. Nevertheless, the levels of private investment remained disappointingly low. In some sectors however there were significant increases in investment in the late 1990s which we investigate in some depth in this study. More recently, since a change of government in 2004, general levels of private investment have picked up and in some sectors the increase has been extra strong. The central concern in this study is to understand why investment in some sectors was so substantial (before and after 2004), paying particular attention to the relationships between policy makers and investors. Conducting research on these relationships was difficult because they were often informal and because we had no template. A detailed report on the research process and findings is presented elsewhere (Abdel-Latif and Schmitz, 2009). This paper distils key features of the approach and above all the findings.

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<sup>4</sup> For a critique see Kelsall and Booth, 2009.

<sup>5</sup> The research program ‘Public Action and Private Investment’ of the Centre for the Future State; the State-Business Relations Cluster of the Consortium for Improving Institutions for Pro-Poor Growth; and the Research Stream on State-Business Relations of the Africa Politics and Power Program. See <http://www2.ids.ac.uk/futurestate/>; <http://www.ippg.org.uk/> and <http://www.institutions-africa.org/>.

<sup>6</sup> For studies on the importance of informal relationships for investment and growth in the history of Mexico and Brazil, see Haber et al. 2003; Bates, 2004; Schmitter, 1971.

Following this introductory section, Section 2 presents the national and sectoral context. Section 3 introduces the conceptual framework and Section 4 sets out the methodology. Section 5 presents the results of the empirical analysis. And finally Section 6 brings together the main conclusions and suggestions for future research.

## **2. The National and Sectoral Context**

This section shows the investment trends in Egypt from the 1960s to date, indicates why a national level investment climate approach has only limited explanatory power and highlights the inter-sectoral and inter-temporal differences which later sections of this paper seek to explain.

### **2.1. National investment trends**

There are no reliable time series on industrial investment but by piecing together the available data<sup>7</sup> (Abdel-Latif, 2007) one can derive the following overall trends for industrial investment in Egypt:

- Industrial investment as a percentage of total investment has declined since the late 1960s. Combined, public and private industrial investment accounted for over 30% in the late sixties and decreased to around 10% in 2005.
- Private industrial investment as a percentage of total private investment decreased from 26% in 1992-97 to 11% in 2000-03, indicating limited interest by the private sector for investment in industry.
- Annual growth rates of both public and private real industrial investment have fluctuated enormously over the period 1970 to 1996, but the overall trend was one of decline, see (Figure 1). Public investment decreased more than private investment following the implementation of Egypt's new economic reform program (ERSAP) starting from 1991.
- Private industrial investment — in real terms — stagnated at a low level from 1998 to 2002 and then declined during 2002 and 2003 due to a wave of divestiture (Sakr 2003). A change of trend is observed from 2004 as investment increases, first making up for lost investments in the previous couple of years, then achieving positive rates of growth from 2004 (Figure 2).
- The positive change in the private investment pattern starting from 2004 coincided with a major cabinet change in the same year involving the appointment of members of the business community to ministerial positions for the first time in Egypt since 1952. It also seemed to be followed by the swift introduction of a number of regulatory changes by the new cabinet, notably the simplification of customs and taxation.

The government presented itself as a successful reformer of rules and regulations and the response of investments in most industrial sectors certainly raises the important question of whether the case of Egypt supports the belief in rule-based governance and its focus on improving the business climate as being the key to increasing investments.

A closer look suggests that this argument has at best very limited validity. Doubts arise for a number of reasons. First, policies to attract investments have been adopted starting as far back as the mid 1970s with major changes such as the laws ending expropriation (nationalization) in the 1970s, the legal provision for equal treatment of local and foreign firms introduced in the 1980s, structural adjustment in the 1990s, intellectual property and labor laws in the early 2000s (Handoussa et al. 2003). These measures failed to have an impact.<sup>8</sup>

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<sup>7</sup> Basic data is collected from the Ministry of Planning (Currently Ministry of Economic Development), various year-reports. Full detailed investment data analysis presented in Abdel-Latif (2007).

<sup>8</sup> For an analysis of the reasons, see El-Mezlawy (2006).



Second, unpacking the overall investment figures does not support the investment climate argument. Figures (3) and (4) compare the investment trends of a number of key industrial sectors in Egypt, revealing substantial inter-sectoral and inter-temporal differences. For example, food industries stand out with superior attraction of private investment while furniture lies at the other extreme. A similar contrast is observed when comparing communications to IT. Some industrial sectors, such as the case of communications, experienced its first wave of substantial investment and growth in 1998 i.e long even before the business-friendly government of 2004 came to power and the recent regulatory changes were adopted.

Third, while there can be little doubt that the simplification of customs and taxation introduced in 2004 helped the business community, other dimensions central to rule-based governance have not improved (for example, inconsistent legislation and weak contract enforcement, not to mention poor understanding and implementation of new legislations such as in the case of the new competition law).

It seems that the most critical change that occurred in 2004 was not so much the improvements in certain regulations but changes in perceptions and attitudes. Our own interviews with owners and managers of large and small enterprises [(Abdel-Latif and Schmitz (2009), Abdel-Latif (2008) and other investigations Yousfi and Humphrey (2008)] suggest that 2004 brought about a greater trust by the business community in government. These new perceptions altered state-business relations favorably and provided space for finding solutions to problems which were often sector-specific. How this took place and why this differed between sectors is the core of the empirical investigation in this paper.

## ***2.2. Salient features of the selected sectors***

The empirical investigation concentrated on comparing two long-established sectors (referred to as ‘old sectors’) and to new sectors. The reasons for selection are set out in Section 4. This contextual section gives a brief overview of their salient features — based on our interviews and technical reports.<sup>9</sup> Specific technical details related to sectors are also presented through the empirical analysis.

### *2.2.1. The old sectors*

The food<sup>10</sup> and furniture<sup>11</sup> sectors are long established traditional manufacturing industries in Egypt. They are both subject to similar institutional frameworks dating back to the 1940s and 1950s. Layers of bureaucracy and often conflicting rules and regulations slowed down, if not impeded, reforms in all manufacturing industries, not just these two. Another similarity between the two sectors lies in their high level of differentiation. They both contain thousands of very small enterprises coexisting with a much smaller number of medium to large ones, many technologically and organizationally backward enterprises but some very advanced ones. This makes it very difficult to organize the business community (in chambers and associations), but the food sector has a more effective and broader-based organization than the furniture sector.

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<sup>9</sup> Such as IMC (2003); IMC (2005); IMC (2006); BSAC (2001); ESCWA (2007); MCIT 1999-2007 monthly indicators; MCIT (2005a and 2005b); ITIDA (2006); ITIDA (2007); Wood Chamber (2005). More detailed presentation of sectoral context is provided in Abdel-Latif and Schmitz (2009).

<sup>10</sup> The industry is divided into six main sub-divisions by product group: 1) processed fruits and vegetables; 2) dairy products; 3) bakery and confectionary; 4) meat, chicken and fish processing; 5) all types of oil; and 6) tea, coffee and tobacco.

<sup>11</sup> Categorized as groups of producers by geographical location (Cairo, Alexandria, Upper Egypt and Damietta), products range from basic production of wooden doors and windows, to highly crafted classic furniture and modern hotel, home and office furniture.

From a value chain perspective, the two sectors show clear differences. With most of the inputs of the food industries locally available, internationally reputed retail chains recently providing opportunities for export production, the food industries value chain has been strengthened over the last few years. In the furniture sector, on the other hand, all raw materials for the industry are imported, local production of accessories is undeveloped, and production of basic products (doors and windows...etc) are not standardized posing bottlenecks on expansion of the main stream sector and large scale production. Nevertheless a small number of large modern companies, specialized in western style furniture, and the Damietta cluster specialized in hand-crafted classic furniture have significant profit and export potential.

### *2.2.2. The new sectors*

Communications and IT (CIT) are both modern sectors and highly interdependent. They both started development more or less around the same time in the mid 1980s, yet their developments took different paths, with the communications industry growing much more rapidly. Their institutional framework is new and dates back to the late 1990s. It suffers from much less bureaucracy and problems with regulations when compared to the case of old sectors.

The structures of the communications<sup>12</sup> and IT<sup>13</sup> sectors are different. The communications sector has a bipolar structure: At one end there is a small number of large enterprises which have made huge investments in the mobile, fixed line and internet networks and operate in oligopolistic or monopolistic market settings. At the other end, there is a large number of small enterprises which have invested in internet cafes and various applications on mobile and fixed line systems. The IT sector, on the other hand, consists of a handful of multinationals, a small number of big national investors, and a large number of small players acting as feeding industries (operating in one part or other of the complete IT solution). The sector also includes IT enabled services, in particular call centers and outsourcing of business process interpretation. This line has received increasing attention from both investors and the government and seems to be expanding fast. It does not require huge investments and at the same time contributes to the solution of two of the country's macroeconomic problems, high unemployment and low export revenues.

## **3. The Conceptual Framework**

As set out in the introduction, we are experimenting with a more political approach to growth analysis. The basic proposition is that informal state-business relationships (ISBR) influence the investment decision by reducing sector specific obstacles and risks, thus making the sector more attractive to investors.

State-business relations can range from hostile to friendly. While 'hostile' versus 'friendly' is clear, friendly interactions can be either 'friendly and useless' or 'friendly and useful'. The difference lies in the existence or non-existence of real collaboration between the two sides towards solving the sector's problems.

We argue that common understanding of problems between key private investors in a specific sector and key policymakers is critical for reaching the 'friendly and useful stage'. We also argue that such common understanding must be associated with perceptions of mutual interests, namely, reduction of specific obstacles and risks for the investors and thus a higher chance of reaping profit, and a better reputation for policymakers associated with boosting

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<sup>12</sup> The communications sector consists of two subsectors: communications infrastructure and diversified applications on mobile and fixed line systems such as ring tones, banking services, advertisements and prepaid phone cards among others.

<sup>13</sup> The IT sector has four subdivisions: hardware, IT services, software development and IT enabled services.

the growth and job creation. We label this particular configuration of state-business relations: Common Interest between Policy makers and private Investors (CIPI).

The literature gives little guidance on how such relationships evolve and at what stage investment inducing effects kick in. We have therefore built a framework for observing the dynamics of informal state business relations (ISBR) and their effects on investment. This heuristic device gives vocabulary and reference points for analyzing real processes.

### **3.1. The model**

Two groups of players are involved in this model: policy makers or top level government officials and private investors in a specific sector. How relationships evolve to reach or not reach the CIPI stage is a function of a number of factors such as previous informal relation between the two groups of players, the leadership characteristics of key investors, organizational capacity of private sector and sector performance indicators among others. The significance of individual factors varies with each relevant phase.

The process of reaching the CIPI stage and impacting on productive private investment is hypothesized to evolve in seven phases: **phase one** - initial relation between the two groups of players; **phase two** - common interest-building stage; **phase three** - common interest-maturity stage; **phase four** - the tipping point; **phase five** - the sectoral knock-on effect; **phase six** - the inter-sectoral knock-on effect; and **phase seven** - beyond the peak. An attempt to capture the hypothesized phases of ISBRs is presented in Figure 4.

The three critical phases in the whole process are phases two, four and seven: **phase two** where the common interest is actually being built, **phase four** when the investment starts to respond (the tipping point) and **phase seven** (beyond the peak) because it addresses the future of CIPI and the possible alternative scenarios. The main characteristics of each phase are as follows:

**Phase One** is the initial relation between policymakers and investors. Common backgrounds (education, social relations etc.) between policy makers and investors facilitate this introductory stage considerably. It speeds up the move into the more serious Phase Two by reducing the duration, transaction costs, ambiguity and uncertainty typically involved in the testing of water between the two parties.

The building of common interest in **Phase Two** is the most critical stage of all. It takes place mostly in informal settings, behind closed doors, because the two parties need to be sure of the outcome of what they are negotiating before taking it to the public arena. Negotiations typically involve promises by the private sector to achieve certain targets in employment, investment and exports in return for policy changes by the government.

**Phase Three** is the phase when policy formulation steps out from behind closed doors to actual public announcement and adoption. It is further enhanced if a formal mechanism for the role played by the private sector in policy formulation is in operation.

**Phase Four**, labeled 'the tipping point', is when investment actually starts responding. The response here is not a simple increase in investment but rather a significant increase that marks the beginning of a new trend where investment is taken to much higher levels.

**Phases Five and Six** are periods over which the knock-on effect of Phase Four can be observed. In Phase Five, boost to local investment creates confidence in the sector concerned and pulls in FDI. In Phase Six, the confidence to invest spreads to other sectors as some of the policy changes induced by CIPI in one-sector benefit other sectors as well.

**Phase Seven** is the phase beyond the peak of CIPI. Here we can distinguish between two very different scenarios: Path A, the path where public-private relationships continue to be effective and Path B is the one where a collapse in the relationships is experienced.

The purpose of presenting these seven phases is not to prescribe what policy makers and investors should do. On the contrary, it is meant as a framework for understanding what actually goes on in the real world.

#### **4. Methodology of Empirical Research**

##### ***4.1. Hypotheses for empirical testing***

The selected<sup>14</sup> hypotheses are to test the validity of key aspects of the model, specifically phases two through four of the ISBR's dynamic path. What follows is a list of those hypotheses which will be examined empirically in the remainder of the paper.

**H.1** State-business relations, whether formal or informal, become effective only when there is a common interest in the sector's growth and common understanding of its problems (the CIPI stage).

**H.2** CIPI plays a critical role in the success or failure of attracting productive private investment to specific sectors and/or sub-sectors.

**H.3** CIPI plays its role through getting policymakers to provide proxy governance benefits to specific sectors or sub-sectors.

**H.4** The impact of CIPI on investment features itself in a 'tipping point', which is a specific point in time when investment actually starts responding in a significant way (taking off).

##### ***4.2. Criteria of choice and rationale***

Three main criteria govern our choice of sectors for detailed empirical analysis: existence of active state-business relations in all chosen sectors to have the basis for enquiring if this new variable has any impact on investment; diversification of sectors to have as confident results as possible away from specificities of sectors; and finally diversified investment trends between sectors to capture the investment effect to the maximum extent possible. Four sectors satisfying the three criteria were selected for empirical analysis: two old sectors (food and furniture) and two new ones (communications and IT).

##### ***4.3. Operationalizing the key variables***

Several problems emerge upon attempting to assess the impact of CIPI on productive private investment: for starters, public-private interactions are difficult to capture because information is not readily available and often confidential which makes CIPI an unconventional and elusive qualitative variable that is difficult to measure quantitatively; CIPI carries from the outset the suspicion of possible corruptive behavior thus making policymakers and investors alike unwilling to explicitly discuss it. Assuming that CIPI does have an impact on investment, it is difficult to isolate CIPI's contribution from all other factors of relevance; and finally, there is the problem of distinguishing the "tipping point" from all other observed peaks in investment.

We attempt to get over the above constraints through three specific techniques: 1) Using a combination of quantitative and qualitative analysis techniques; 2) reliance on detailed formal and informal flexible format interviews for collection of qualitative data; 3) improvising

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<sup>14</sup> The full empirical research is presented in Abdel-Latif and Schmitz (2009).

qualitative tools for monitoring the construction of CIPI and how CIPI can impact investments.<sup>15</sup>

#### **4.4. Sources of information**

The quantitative information comes from official sources such as GAFI (General Authority for Investment), GOEIC (General Organization for Export and Import Control) and the MCIT (Ministry of Communications and Information Technology) and quasi-official sources such as the FEC (Food Export Council), FUEC (Furniture Export Council), IMC (Industrial Modernization Centre) and various business associations and industrial chambers within FEI (the Federation of Egyptian Industries).

The qualitative information, particularly critical for understanding the state-business relations, comes from a total of 61 interviews. Table 1 shows how these interviews were distributed between government and business leaders. The latter includes mainly investors but also a small number of heads of business associations/industrial chambers — most of whom were leaders of both enterprises and associations/chambers.

In addition to the main interviews with key players in the four sectors of focused analysis, short enquiries and conversations with numerous people from different sectors on specific aspects were also conducted so as to fill gaps in our understanding<sup>16</sup>.

Some interviews were more important than others. Particularly critical, were the interviews with the top decision makers in government and in business — obtained by careful negotiation and promise of confidentiality. Whenever possible, triangulation was conducted across interviews, and information obtained in interviews was cross checked with other sources including legal documents and published and unpublished reports.

### **5. Results of Empirical Analysis**

As stressed in the introduction, this paper experiments with a new approach which concentrates on state-business relations and the difference they can make to initiating investment and growth. The presentation of findings is organized around the four hypotheses set out earlier, but repeated in the course of this section.

#### **5.1. Key features of effective state-business relations**

**Hypothesis 1:** State-business relations, whether formal or informal, become effective only when there is a common interest in the sector's growth and common understanding of its problems (the CIPI stage).

Empirical investigation revealed many incidences of public-private interactions in all four sectors and others<sup>17</sup>, going on sometimes for years with no real positive impact on the sector. Policymakers and investors were speaking different languages, and did not see common grounds or interest in listening to the other side. The sector specific public-private interactions were initiated by business associations and semi public institutions, which had private representation. Such formal interactions were of little consequence. Informal relationships seemed to be more effective in overcoming previous gaps in communication and trust. Elsewhere we have highlighted how these informal ties helped (Abdel-Latif and Schmitz, 2009). Informality facilitated but was not the key.

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<sup>15</sup> Tools presented in section six along with empirical analysis.

<sup>16</sup> For example we spoke with 20 exhibitors at an IT trade fair about their participation in business associations and chambers and their general impression of the relation between the government and business in their sector.

<sup>17</sup> Such as garment industry, auto components, auto industry and marble and granite.

In the course of the interviews it became clear that mutual interest was a necessary (but not sufficient) condition for effective interactions. Mutual interest means that the investor perceives that the policy maker has a stake in the investment, in the sense that making it happen and succeed would enhance the policy maker's reputation, career and power. In turn, the policy maker perceives that the investor needs his or her assurance that complementary action by the state will take place. Both sides would lose if the investment would not occur.

The interviews showed that such common interest was particularly clear in the food and communications industry. As will be shown later, it led key investors in the food industry to invest, increase exports and employ more people; policymakers removed bottlenecks by adopting unconventional measures. Similarly in the context of the new industries, the big communications and IT companies were willing to make their substantial investments because they saw the gains that could be reaped from being first movers in new markets. Policy makers negotiated deals with these companies because they believed that the new technologies had a chance in their ancient country and saw a chance of carving out a career by supporting the new industries.

Empirical analysis revealed that the willingness of the policy makers to take action in favor of a certain sector is conditional upon, and proportional to, the potential of the sector itself and the extent to which it can achieve visible and tangible results in terms of increased investment, exports and job creation that would give the policy makers credit. In fact it was stated by one highly prominent policy maker, on a confidential basis, that even though the support of the Ministry of Trade and Industry is offered across the board to all manufacturing industries, it concentrates on a number of specific sectors or often subsectors because they have higher growth potential. Food industries, for example, received much more attention by policymakers than the furniture sector because the former is a bigger contributor to industrial output, employment and exports. There is a stronger political incentive to promote the food sector.

In the case of CIT, policy makers did not deal with all subsectors at once and gave initially most attention to the buildup of a communications infrastructure for which they needed in particular the involvement of companies who could make big investments.

The interviews suggest, however, that mutual interest of policy makers and investors in the sector is not sufficient in itself but that it has to be combined with common understanding of problems that need to be solved. In the case of the food sector the common understanding of problems and potential solutions was greatly facilitated by the fact that the Minister of Trade and Industry himself was, until he became the Minister, a prominent businessman in the food industry. Similarly, the policy makers connected to the communication and information technology industries were not the usual career politicians or bureaucrats. They came from a small pool of specialized Egyptian professionals who understood the technicalities.

These public-private interactions at the sectoral level seem to have benefited from the cabinet change in 2004 which brought business leaders into public positions. Trustful relationships, based on informal ties, between these new cabinet members brought about a network of fast decision-making within the cabinet rendering policy changes easier and smoother than before. The sectoral public-private alliances thus extended into the 'engine room' of economic policy making. As a result the willingness to take action in support of specific sectors, translated into the capacity to take action.

The empirical details for these findings on public-private relationships are presented elsewhere (Abdel-Latif and Schmitz, 2009). The key point to be made here is that common interest and common understanding of the challenges emerged as the key attributes of effective relationships. Previous informal ties helped but were not a necessary condition.

## **5.2. CIPI and investment**

**Hypothesis 2:** CIPI plays a critical role in the success or failure of attracting productive private investment to specific sectors and/or sub-sectors.

This hypothesis addresses the most important question raised by this study: Is there a role played by CIPI in attracting investment to specific sectors or sub-sectors? If so what is that role? And is there enough evidence to reach a confident conclusion?

This part of the empirical investigation was quite demanding and sensitive because to say that the relationships with the policy makers has a critical impact on attracting investment sounds corruptive and improper and thus the expected immediate answer of all interviewed was ‘of course not’. This meant that the real situation could only be inferred from what they said, and needed to be cross checked several times for validity. To unravel the chain of causality, a detailed exploration into the reasons behind success or failure in attracting investment had to be conducted at the level of each investor interviewed in order to capture the significance or insignificance of the changes facilitated by CIPI.

It became clear from the outset that all interviewed business people from the food and furniture sectors see ‘profit potential’ as the number one reason for investing. Elements of CIPI emerged in the interviews with food investors immediately as soon as questions concerning constraints facing investors were addressed. This was followed by debates with each investor on the role of CIPI as such. Only one investor explicitly stated that he would not have expanded his investments if it were not for CIPI. All the others denied that CIPI and proxy governance granted can solely be a reason behind investment. None of them, however, said an explicit ‘no’ to the following question: With economic profitability established, would you have invested anyway if certain policy actions had not been taken and the bridges of trust had not been built with the government?

This seems to point to the important role played by CIPI in unleashing the full profit potential of the sector through unblocking the way forward, solving chronic problems and reducing the risks faced by potential investors. Answers of interviewees to more specific questions on constraints to investment supported this conclusion. The strength and effectiveness of CIPI varied however by subsector and processed fruits and vegetables (preservation, freezing and dehydration) enjoyed the biggest share of problems solved through CIPI because it is the largest subsector and biggest export revenues earner and employer among all food industries. Investment in this specific subsector increased by 615% between 2003 and 2004 and by 71% between 2004 and 2005, reaching unprecedented levels of L.E 965.9 million and L.E 1650.3 million in 2004 and 2005 respectively, values that are much higher than L.E 379.6 million in 1998, the highest observed investment value in any specific year through the whole period (1995-2003).

The most striking examples for CIPI's role in attracting investment to the communications sector came from the governmental agreements with the first two mobile companies and the process of introducing the third one. The profit potential was high but — in the late 1990s — there was no framework and there were hardly any processes for regulating this sector. Formalization and institutionalization would take a long time and was not in the policymaker's and investor's interest. Transitional solutions were found based on common interest and common understanding of the complicated technical and economic issues involved. Investment responded in a major way. Real investments in communications in 1997 hardly exceeded L.E 70 million and suddenly jumped to L.E 2.6 billion in 1998, then to L.E 7.3 billion in 2006.

Conclusion: in both old and new sectors it would be wrong to attribute the causality of the investment rise to CIPI or to any other individual factor as the investment decision is quite

complex and involves a number of factors. What is confirmed here, however, is that in situations where the profit potential is good but not realized, CIPI is essential for unblocking the way forward in the short and medium term. It helps to remove obstacles and provide assurances which then trigger the investment.

### ***5.3. CIPI and proxy governance***

**Hypothesis 3:** CIPI plays its role through providing proxy governance benefits to specific sectors or sub-sectors.

Discussing CIPI's role in attracting investment to specific sectors or sub-sectors is not useful unless we explore how such a role is being played. We examined this role by assessing the contribution made to what we call 'proxy governance' in favor of the sector/s or investors in question. This meant examining the policies and actions that meet their specific concerns and needs.

Unlike the horizontal policy measures adopted by the government in the area of customs and taxes that attracted international attention and are reflected in Egypt's improved 'Doing Business' indicators over the period 2006-08 ([www.doingbusiness.org](http://www.doingbusiness.org)), it is less well known that there were a number of selective interventions focused on specific sectors. Our concern was to establish whether these interventions had their roots in CIPI. Indirect questions had to be used to collect evidence. Table 2 presents different types of proxy governance and where each type has been most observed.

Some specific examples are protection of specific property rights such as land allocation to big investors, policies of specific technical nature such as giving priority to harmonization of food standards for 2000 items, having private sector board members from the food business community in public institutions, among others. The interviews suggest that such interventions were critical for triggering the investment and were greatly facilitated by CIPI. Proxy governance was clearest in the communication sector where CIPI led to arrangements, concessions and commitments of mutual interest as the investments at stake were huge. In the IT sector, proxy governance helped to compensate for deficiency in institutional capacity. In some cases, the special arrangements extended to foreign companies.

Empirical evidence also revealed that in the short and medium terms, proxy governance seems to reduce the immediate uncertainties and risks associated with the investment decision in a specific sector much more directly than the general enabling does, if at all. Evidence was found not only for the case of local private investors but also for foreign direct investment by multinationals, known to be cautious and volatile. In the long run, however, most interviewees indicated that a fully enabling environment at both the country and sectoral levels is needed to support sustainable investment and growth in the country under the longer time frame.

Conclusion: the interviews and actual policy changes confirm that CIPI has led to proxy governance benefits to the sectors. In the old sectors proxy governance dealt with chronic problems of the sectors while in the case of the new sectors it concerned concessions and commitments of mutual interest to help communications sector get quickly established while in the case of IT, proxy governance helped to compensate for deficiency in institutional capacity.

### ***5.4. The tipping point***

**Hypothesis 4:** The impact of CIPI on investment features itself in a tipping point which is a specific point in time when investment actually starts responding in a significant way (taking off).



Figure 6 suggests a strong increase in investment over the period 2003-08. The year in which investment started to respond significantly was 2004 and this could therefore be considered the tipping point. Investment shot up further in 2005 but then seemed to decline equally fast. The latter however is misleading; investment continued to be significant but some of it was associated with mergers and acquisitions which are not captured in the investment statistics of GAFI. While allowing for irregularities in the data, it seems that over the period 2003-08 there was a step change in the investment level. However, not enough time has elapsed to confirm a complete change in trend.

There are other indicators which suggest that the food sector made a step change in recent years. There was a strong upward trend in food exports as shown in Figure 7. Some food enterprises interviewed stated that over the period 2005-08, they increased their investments by 300 and 400% in order to meet increasing demands for exports. More importantly, the food industries value chain has been strengthened by a stronger retail chain, food standards conforming to international standards, a national food authority and unified food law. In other words, the institutional infrastructure is almost complete, indicating that the sector can take off on its own.

A critical question is whether the increases in investment and exports were due to CIPI? As indicated earlier, CIPI cannot be considered a cause but a facilitator. The driving force for the investment was demand, but the ability to respond to increases in demand over several years and remove supply constraints was greatly facilitated by the cooperation between government and business.

The communications sector is different from other sectors as its main component 'the infrastructure' does not occur as a continuous flow of investment but rather comes infrequently in huge bulks in scattered points in time. With this reservation in mind it is observed (in Figure 8) that big increases in investment occurred in both 1998 and 2006. The first is associated with the introduction of the physical infrastructure of the first two mobile companies, while the second is associated with the entry of the third mobile company.

The period between 1998 and 2006 — and beyond 2006 — witnessed a lower value for but a higher number of investments still categorized as 'communications' but classified as communication applications on mobile and fixed lines (such as entertainment, ring tones, banking, advertisements, prepaid phone cards and others). The year 1998 is confirmed to be the tipping point because all investments that followed through the following ten years would not have been possible without this first initial base in infrastructure, not to mention the transformation in the communications infrastructure in Egypt as presented in Table 3 comparing key performance indicators between 1999 and 2007.

Investment in IT is different from investment in traditional sectors as well. It is demand driven with the government as the main customer (no less than 60%). IT is also featured by a large sized informal sector involving individuals working from home and not accounted for at all in official statistics. Again keeping these technical reservations in mind, it is observed (in Figure 9) that a big boost in IT investments seemed to take place in 2005 particularly in the areas of hardware, software applications and IT enabled services (in specific, call centers).

Can 2005 qualify as a tipping point? Similar to the case of food industries, not enough time has elapsed to reach a conclusive decision. On the positive side, from a technical point of view, the observed push in IT in 2005 followed the boom in communications on which it is highly dependent (for example, the case of IT enabled services and the big demand for IT products by the big mobile companies). It also followed the initiation of the e-government project and the decision to establish ITIDA, the key institution to regulate most aspects of the IT industry, both of which took place in 2004.

Moreover, in spite of the relatively lower levels of new investments in 2007, all interviewees agreed that the profit potential of IT activities following the boom in communications, and the positive steps towards completion of the institutional framework of direct relevance to the IT sector, have had a positive impact on increasing the attractiveness of the sector for investment leading to a rush of new investments from 2005 onwards. Their statements are supported by IT performance indicators in Table 3. However, there are a number of constraints which hold the sector back. The absence of norms and procedures or quality standards for IT operations, the limited pool of well trained human resources in all disciplines and the reliance on family enterprises, all imply that the sector may still not be ready to take off.

Conclusion: The existence of a tipping point can be confirmed only for the communications industry because over ten years have elapsed and indicators support the take-off of investments in this sector. The same could not be said about the food or the IT sectors. While several tipping point indicators are observed in the two sectors, other observations call for caution in rushing to a conclusion either way. With regards to the causal connection between investment increases, it is worth repeating the earlier conclusion that CIPI is not the cause but only a facilitator or a catalyst for investment.

## **6. Conclusions**

This research is not trying to discredit the importance of improving the general investment climate in developing countries. There is an established long-term objective of improving the general enabling environment but this takes a long time. In the meantime there is a need to find practical ways of pushing investment up in the short and medium terms. This paper agrees with those who seek ways forward by conducting context-specific analysis and concentrating on specific constraints. Growth diagnostics does this by identifying binding constraints at the national level.

This paper experiments with an approach which takes the sector as the most relevant context and deals with the issue of practicality by incorporating politics into the analysis. The relationship between policy makers and investors is put centre stage. The proposition is that when their interests are aligned, obstacles to investment and growth are more likely to be removed. There is a lot of resistance — in the research and policy making community — to the idea that such an alignment of interest can do good. What dominates is the suspicion that such alignments are abused to pursue narrow interests. We are not blind to this danger; it is real. But we are also open to examining the growth-enhancing effects that can come from cooperation between policy makers and investors.

### ***(a) State-business relations and investment***

The research was prompted by observing major differences in investment and growth between industrial sectors. Our overall question was whether such differences could be explained by state-business relationships. This was broken down into sub-questions: What were the critical features of effective public-private relationships? Was there a causal connection between such relationships and increases in investment? If there was a connection, how did it work?

The paper suggests that common interest and common understanding of the challenges to be addressed are the key features of effective public-private relationships. When relationships reach this stage, they can play an important role in increasing investment. But the paper also warns against overstating this role.

The research shows that state-business relations are not the sole cause of increases in private investment, but they do play a critical role in unleashing the profit potential of the sector. In

the food sector the direct reason for the increase in investment was favorable demand, but the ability to overcome supply constraints and make effective investments owes much to the relationships between policy makers and investors. Whether the power of demand would have eventually removed these constraints is hard to tell. It would certainly have taken more time.

State-business relations proved very useful in overcoming barriers by providing what we called proxy governance consisting of measures tailored to the specific needs of the sub-sector. It also facilitated difficult and politically sensitive decision making, for example the removal of restrictions on access of investors to reclaimed desert land, and the removal of the energy subsidy. This emerged most clearly from the analysis of the old sectors. The barriers that needed to be overcome were more formidable in the case of the new sectors. Informal state-business relations (ISBRs) played a critical role in helping Egypt to establish impressive communication and information technology industries, virtually from scratch.

Specifically, they helped the country overcome the initial barriers to entry whether of technical nature, security related<sup>18</sup>, or even just mental blocks (translated into red tape) of conservative technocrats. Later on, they helped to get over the institutional deficiencies, limited experiences and capabilities of Egypt. Such actions and surges would have been difficult if not impossible in a country that in many ways was falling behind Asian competitors and even some countries in the region. While not all actions were necessarily in the right direction or completely devoid of corruption, the fact remains that Egypt now has a substantial and viable CIT industry. The role played by informal state-business relations (ISBRs) in developing the industry is gradually receding as the institutional framework gets more developed and industrial structures and capabilities become stronger.

In both the old and new sectors, the close alliance between high level policy makers and big investors was able to play a key role because the alliance extended to the cabinet, and in the case of the CIT industries, to the President. This helps to explain why the willingness to take action translated into a capability to take action. It is impossible to determine how effective the alliance would have been without this extension to the top.

The willingness of policy makers to take action in favor of a certain sector is conditional upon the potential of the sector itself, and the extent to which it can deliver visible and tangible results in terms of economic growth, exports and job creation for which policymakers can take credit. This explains why policymakers took particular interest in the food sector (especially the processing of fruit and vegetables). In the case of the CIT industries there was also the prestige and pride in establishing a new industry in a country which is famous for its ancient history but not for future-oriented hi tech.

### ***(b) Questions for future research***

As set out in the introduction, we are experimenting with a new approach to explain, and potentially foster, investment and growth. This paper has shown some of the results of this work. The overall conclusion is that a sectoral approach, which gives particular attention to the role of public-private relationships, has generated important insights on how blockages to investment and growth were overcome. But there are also unanswered questions. What follows are some of the key questions that future research needs to address.

State-business relations — when they are driven by common interest and informed by common understanding of problems — have been shown to play an important role in initiating investment. The question is whether they play an equally important role in sustaining investment and growth. In other words, we need to distinguish between different

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<sup>18</sup> National security issues (due to technical issues on wave length and interactions with defense and intelligence etc).

stages. The common search for best practice (best in all places and at all times) makes it difficult to recognize ways forward for a particular stage and to understand sequence and dynamics. The research presented in this paper suggests that it is useful to work with the notion of transitional arrangements. The (largely) informal cooperation between key policy makers and investors were effective transitional arrangements — effective for overcoming specific obstacles and initiating a process of investment and growth. Whether they would work for sustaining the growth process is not clear. Equally, whether informal relationships can or should be institutionalized on a longer term basis remains to be explored.

Another group of questions concerns the conditions under which informal alliances between key policy makers and investors can have a growth enhancing effect. This paper has brought out the positive role which such alliances can play. Most of the literature emphasizes the negative effects arising from rent seeking and the pursuit of narrow interest. The challenge is to specify the conditions under which one or the other effect is more likely. The determinants worth investigating include: open versus closed public-private alliances, broad versus narrow-based business associations, upward accountability of the policy maker, scrutiny by the press or other media, consumer protection, competition law and competitive pressure.

Informal public-private alliances will always be a controversial topic. Research on the above questions would help to have a debate which is less influenced by prejudice and based on a realistic and differentiated assessment.

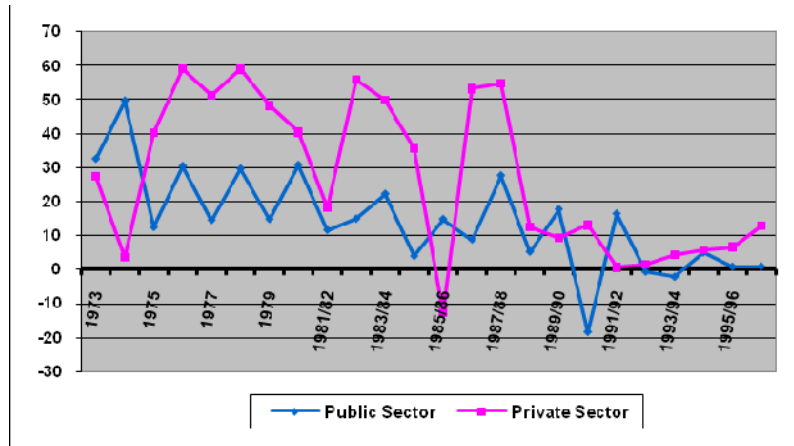
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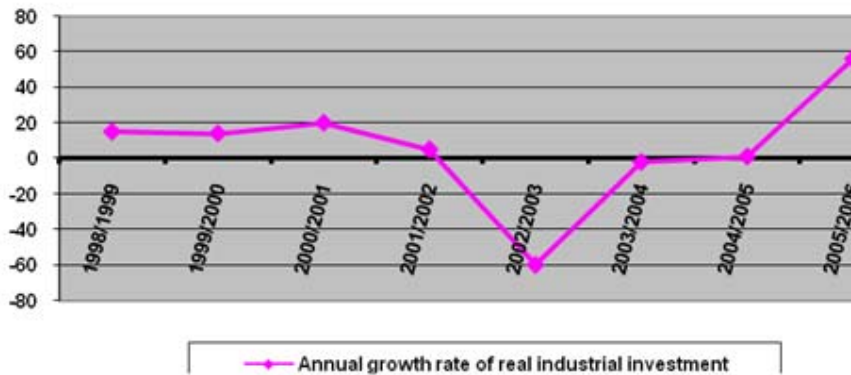
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**Figure 1: Public and Private Industrial Investment: Annual Growth Rates 1973-1996<sup>19</sup>**



Source: Ministry of Planning (Currently Ministry of Economic Development).

**Figure 2: Annual Growth Rate of Real Industrial Investment 1998/99–2005/06**

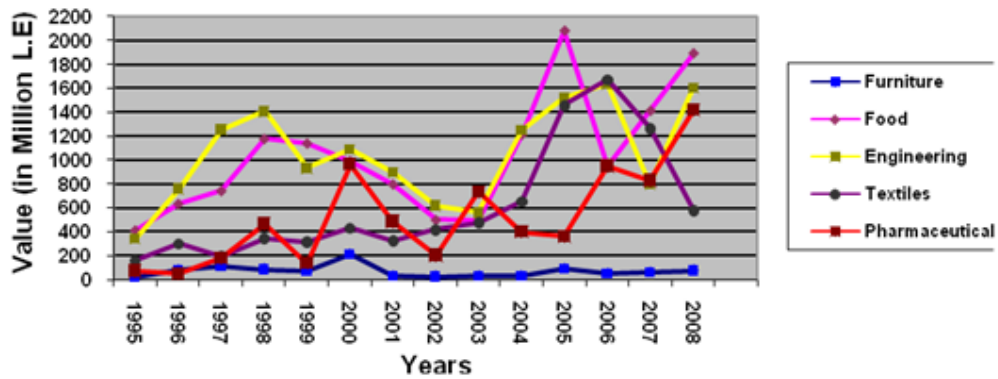


Source: Ministry of Planning (currently Ministry of Economic Development)

<sup>19</sup> Starting from 1981 a new fiscal year accounting system was introduced whereby the fiscal year starts in July and not in January like the regular calendar year.



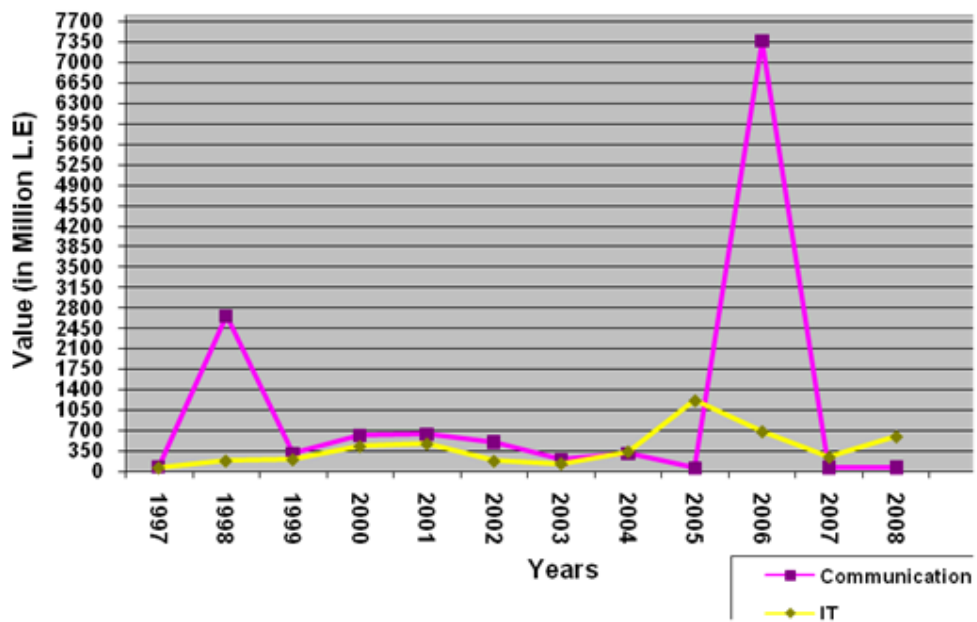
**Figure 3: Annual Real Investment in Some of the Manufacturing Industries (1995-2008\*)**



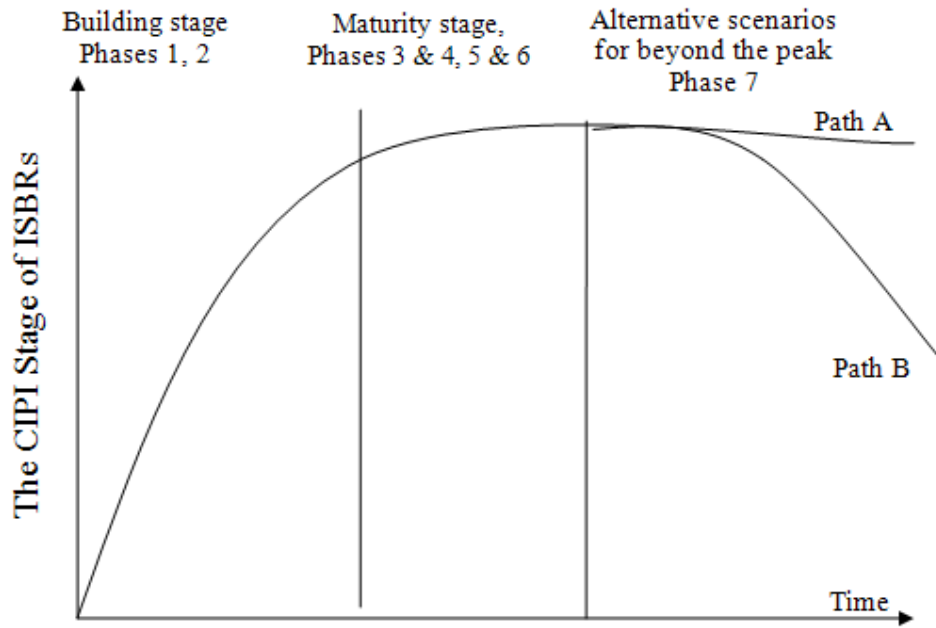
\*Until the end of November 2008.

Source: GAFI- nominal investment data deflated by authors.

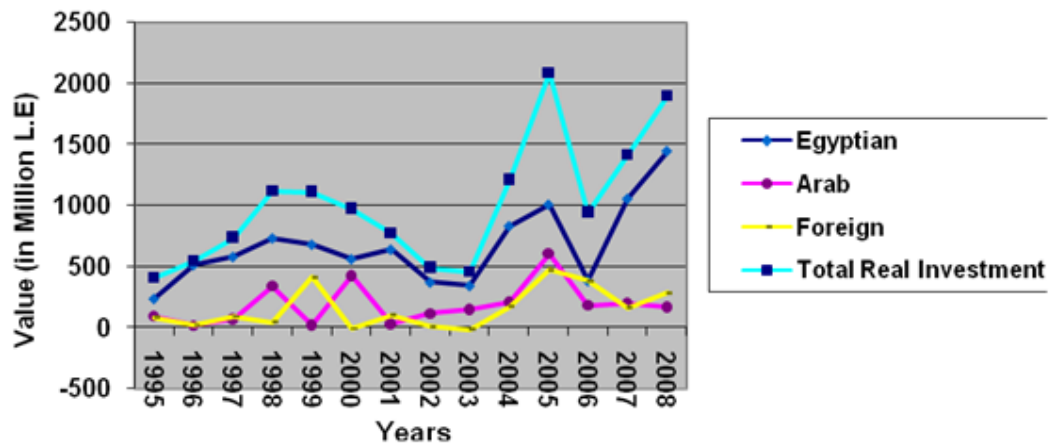
**Figure 4: Annual Real Investment in Communications and Information Technology (1997-2008)**



**Figure 4: The CIPI Path**



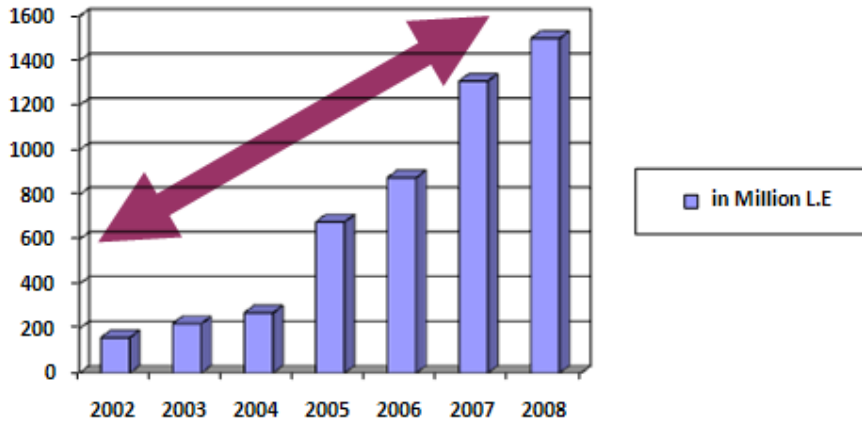
**Figure 6: Annual Real Investment in Food Industries (1995-2008\*)**



\*Until the End of November 2008.

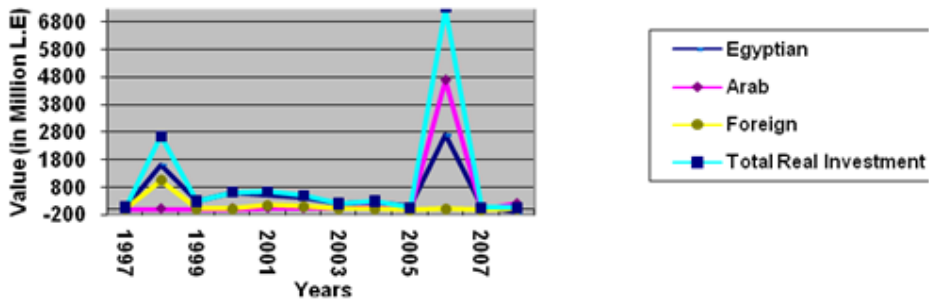
Source: GAFI- nominal investment data deflated by authors.

**Figure 7: Egyptian Food Exports 2002-08**



**Source:** Calculated by the authors on the basis of export data provided by the General Organization for Exports and Imports (GOEIC) and the Food Export Council.

**Figure 8: Annual Real Investment in Communications (1997- 2008\*)**

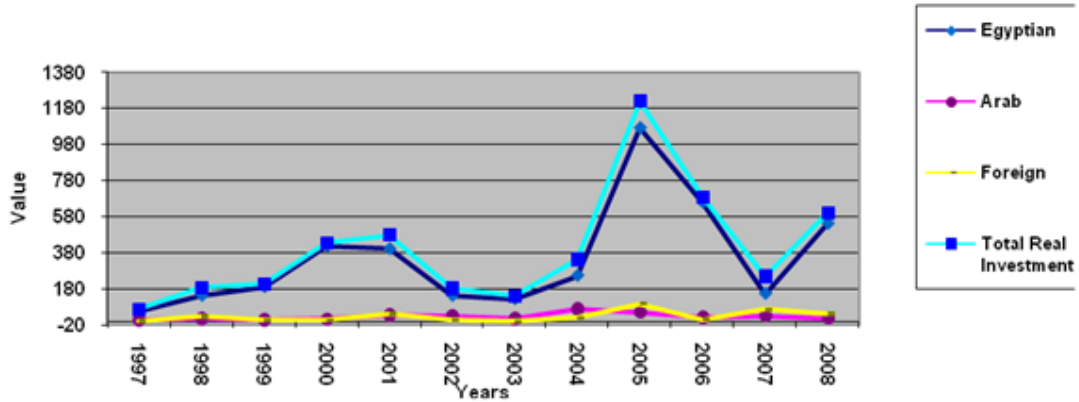


\*Until the end of November 2008.

**Source:** GAFI- nominal investment data has been deflated by authors.

**Figure 9: Annual Real Investment in IT Sector (1997-2008\*)**

(in million L.E)



\*Until the end of November 2008.

Source: GAFI- Nominal investment data has been deflated by authors.

**Table 1: Interviews in Old and New Sectors**

| Actors           | Old Sectors | New Sectors | Total |
|------------------|-------------|-------------|-------|
| Policy Makers    | 10          | 8           | 18    |
| Business Leaders | 22          | 21          | 43    |
| Total            | 32          | 29          | 61    |

**Table 2: Examples of “Proxy Governance” Benefits to Different Sectors**

| Type of proxy governance  | Sectors where it was most observed                        |
|---|---|
| Protection of specific property rights  | Food and communication                                    |
| Specific policy changes of technical relevance of the sector                  | Food, communication and information technology            |
| Reduction of uncertainties in relation to transaction costs and public duties | Food, furniture, communication and information technology |
| Provision of support services and infrastructure                              | Communication and furniture                               |
| Adoption of a clear long term vision for a particular sector                  | Food and communication                                    |

**Table 3: Some Key Performance Indicators of the CIT Industry 1999 - 2007**

| Sector/subsector   | Unit      | 1999   | 2007   | Growth rate 1999 -2007 |
|--|-----------|--------|--------|------------------------|
| <b>Communications</b>  |           |        |        |                        |
| Telephone fixed lines in operations                                    | Million   | 4.9    | 11.16  | 127.8                  |
| total cellular mobile  |           |        |        | 4390.5                 |
| Telephone subscribers  | Million   | 0.654  | 29.368 |                        |
| fixed lines Tele-Density   | %         | 7.6    | 15.14  | 99.2                   |
| total cellular mobile  |           |        |        | 3877                   |
| Tele-Density   | %         | 1      | 39.77  |                        |
| waiting list of fixed lines  | Thousands | 1265   | 25.934 | -98                    |
| total public pay phones Cabins   | Thousands | 13.305 | 56.444 | 324.2                  |
| <b>Internet</b>  |           |        |        |                        |
| internet users   | Million   | 0.3    | 8.29   | 2663                   |
| internet users/ 100 inh.   | %         | 0.58   | 11.225 | 1835.3                 |
| int. internet bandwidth  | MBps      | 0.02   | 14556  | 72779900               |
| int. internet bandwidth/10,000 inh                                     | MBps      | 0.038  | 1.974  | 5094.7                 |
| <b>Information technology</b>  |           |        |        |                        |
| Established companies in IT & communications                           | Company   | 266    | 2327   | 775                    |
| Established companies in IT & communications /100 thousand inhabitants | Company   | 0.42   | 3.151  | 650                    |
| IT clubs   | Club      | 30     | 1593   | 5210                   |

**Source:** Ministry of Communications and Information Technology (1999 and 2007 monthly indicators).