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Politics Affect Exports in Egypt

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In a nutshell

- *Investment-related regulations are a major determinant of the firm's decision to expand its activities and enter the exports market.*
- *Despite recent reforms of investment related laws and regulations, exports continue to drop.*
- *Exporters in Egypt face a number of constraints varying between political instability, unequal competition from state owned firms, and complicated business-related procedures.*
- *Political stability and political leverage of state-owned firms are both the main obstacles hindering exports in the private sector.*
- *Serious implementation of reforms, ensuring competition and transparency in the market are indispensable to support exporters in line with the 2030 Strategy.*

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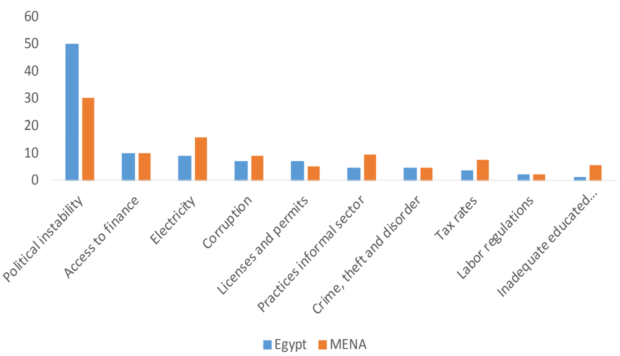
Experiences from several developing countries show that the investment climate is a strong determinant of productivity and exports (Dollar et al., 2004 and Escribano et al., 2010). In India, labor productivity decreases by 44% in those States who suffer from a poor investment climate. In Pakistan and Bangladesh, power outages and delays by customs authorities are bottlenecks for manufacturing firms. Improvements in regulation, competition, access to finance and infrastructure have been shown to increase export volumes across countries with different income levels. Firms make the decision to enter the exports market when they are productive enough to cover the fixed costs of establishment of an exporting activity. This is why the ease of doing business in a country is likely to increase firms' productivity and encourage them to become exporters or to expand and diversify their exporting activity if they are already on the exports market.

In the MENA region, the investment climate seems to be overall poorer than in other developing countries and MENA firms are less export-oriented than their peers elsewhere. In the case of Egypt, for example, the World Bank's Doing Business Report ranked the country as top reformer in the MENA region for five years in a row between 2004 and 2008. The economy has been, however, facing several challenges since the political turmoil in 2011. Despite recent reforms targeting better investment opportunities and increased exports activity, exports did not increase and the number of exporters has declined. This problem needs to be further understood to help address the main shortcomings in the current setup and to help design more sound policies that cater to the need to restore the economy's export competitiveness and re-integrate it into the world economy.

Doing business in Egypt: opportunities and constraints

Political instability since 2011 had a negative impact on business and investment in Egypt, where investments dropped from 22.4% of GDP in 2008 to 14% in 2014 and exports from 30% to 15.2% of GDP over the same period. In 2013, the World Bank Enterprise Survey shows that nearly 50% of firms report unstable political conditions as the main obstacle to their operations (see Figure 1).

Figure 1: Perecent of Firms identifying the problem as the main obstacle



Source: Constructed by the authors using the World Bank Enterprise survey (2013).

Moreover, according to the Doing Business 2016 Report, Egypt's rank is 131st out of 189 countries in the ease of doing business (see Table 1). Within the MENA region, the ranking of Egypt is better in terms of starting a business and getting credit. However, licensing and taxing procedures, as well as corruption indicators are shockingly higher in Egypt than in MENA and among lower middle-income countries. Despite the measures taken to facilitate trading through borders, the number of procedures, delays at the border and cost of clearing exports and imports remain also major obstacles to Egyptian firms.

Table 1: Doing Business global ranking for Egypt (2015/2016)

Doing Business Indicator	Global Rank	Ranking among MENA countries	Ranking among Lower Middle-Income Countries
Ease of doing business	131	14	29
Ease of starting business	73	3	14
Dealing with construction permits	113	12	22
Getting electricity	144	18	34
Getting credit	79	1	22
Paying taxes	151	18	35
Trading across borders	157	14	38

Source: Constructed by the authors using the Doing Business Database (2015)

Nearly 72% of Egyptian firms responding to the World Bank Enterprise survey also reported having been expected to give gifts to obtain operating licenses, compared to around 20% in the two other groups. The very same reasons also explain why nearly 90% of these firms have started as unregistered, and why informality prevails among small and medium enterprises (SMEs). Indeed, small and medium firms represent a large share of the manufacturing sector in Egypt (nearly 97%), but are underprivileged in access to credit (only 25% of total non-government credit facilities goes to SMEs) and in export activities (only 6% are trading).

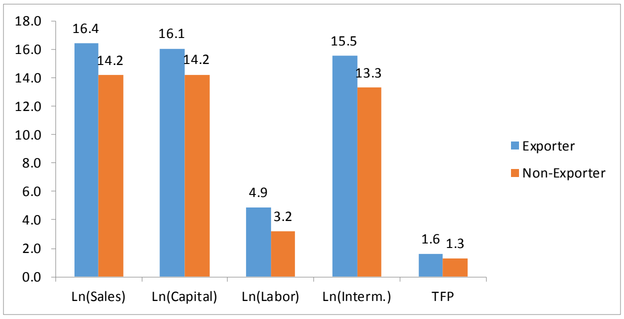
Hence, to improve investment climate and exports, the Egyptian government started a first series of successful investment and export promotion policies in the period between 2004 and 2008, resulting into a rise in both until 2010. With the overall slowdown in the wake of the revolution, investments and exports have sharply dropped, forcing the government to respond by offering more incentives to investors covered by the Investment Law 17 of the year 2015. Reforms ranged from streamlining investments regulations, reducing customs tariffs and sales tax for exporting firms, enhancing the role of the Competition Authority, and further investment-related incentives and guarantees provided by the Investment

Law-Decree No. 17 of the year 2015 and the new Investment Law of the year 2017. These include free allocation of land, reduced energy tariffs, a more efficient licensing system and enhanced investor-government dispute settlement mechanisms. However, they still face serious impediments related to the investment climate. Despite the reforms implemented by the government of Egypt, neither exports nor the number of exporters increased since they represent only 20% of the total number of manufacturing firms.

Examining the Impact of Investment Climate on Exports Performance

Egyptian exporters from the manufacturing sector are chiefly concentrated in food, textiles, garments and chemicals. They are larger than non-exporters in terms of sales, labor, capital and use of intermediate inputs (see Figure 2). Moreover, their total factor productivity (TFP) is higher than their non-exporters counterparts (Melitz, 2003). Yet, as it was mentioned before, they are still facing several impediments that hinder their export performance.

Figure 2: Characteristics of Exporters vs. Non-Exporters



Source: Constructed by the authors using the WBES.

To examine the impact of investment climate on exports performance, we undertake our empirical analysis in several steps, extending hereby the work of Dollar et al (2004). Indeed, since productivity is one of the most important determinants of becoming an exporter (Melitz, 2003), we first estimate the total factor productivity through the logarithmic form of production function (including labor and capital) and retrieve the logarithm of TFP as the residual at the sectoral level. In the second step, we regress[1] the probability of becoming an exporter (the extensive margin) on several independent variables that include the estimated TFP, ownership (whether the firm ownership is public, private or foreign), the share of imported inputs and a vector that includes six groups of variables measuring the investment climate that are likely to affect the decision to export. The first group incorporates infrastructural variables such as electricity, telecommunication and transportation. The second is dedicated fiscal policy including tax administration and tax policy. Third, a bunch of variables measuring the labor market regulations are taken into account, followed by variables measuring access to finance. Fourth, we measure trade facilitation issues by the length of customs procedures. Fifth, we include the risks coming from corruption, theft, problems with courts and political instability. Finally, we include some variables measuring competition coming from the informal sector. All these constraints are dummy variables that take the value of 1 if the obstacle is severe or major and zero otherwise.

The third step is to examine the effect of investment climate on the intensive margin. A similar regression is run where the dependent variable is the share of exports in total sales. We use manufacturing establishment surveys carried out by the World Bank (World Bank Enterprise Survey) in most developing countries over the last decade and a half, including several from the Arab world. For Egypt, we use the 2013 survey.

Our analysis of the probability of entry in the export market show that two factors of rather political nature hinder Egyptian firms. First, the variable measuring political instability exerts a significantly negative impact on exporters as it has largely discouraged potential exporters. Indeed, between 2011 and 2013, economic performance and exports have dropped, coupled by capital outflows, downsizing and exit of

[1] We add industry and governorate dummies to control for the sectoral and regional characteristics. This regression is run using a probit model.

several domestic and foreign firms. Second, the variable measuring government ownership is positively associated to the likelihood of becoming an exporter. Indeed, domestic private sector firms are in an underprivileged position compared to state-owned and foreign firms who enjoy an easier access to the export market. Obviously, Egyptian public-sector firms are able to benefit from their position to easily overcome any barriers imposed by other government authorities and enjoy a better access to information enabling them to enter the export market although they have the lowest TFP estimated from our regressions. Moreover, firms with foreign ownership also enjoy a privileged and easier access the international market due to the nature of their ownership. By contrast, the Egyptian private sector suffers from unfair competition with well-connected public and foreign firms.

The analysis on the intensive margin shows, however, state owned firms are unable to increase their exports once they enter the market. According to our findings, the share of exporters among foreign firms is 1.8 times higher than that among government firms, but the share of exports by the former is 2.7 times higher than for the latter. Again, the implication of this finding is important, since it provides an insight into the Egyptian manufacturing sector, and raises questions on transparency, access to information and competitiveness of firms located in Egypt. While state owned firms seem to enjoy the privilege of entering the exports market due to the lack of barriers and privileged access to information, in addition to formal (and informal) communication channels with the authorities, these are – however- unable to compete and expand their export activity. On the other hand, foreign firms do better overall than government and local private firms in entering the exports market and in competing internationally and expanding their exports.

In addition to firm ownership as an important factor determining exports, competition coming from the informal sector is one of the main variables hindering registered firms from entering the exports market and from increasing their exports. Informality has become a widely pervasive phenomenon in Egypt in the recent years, and poses a relative threat to the expansion of registered firms. Being able to provide cheaper products, informal firms provide a source of fierce competition affecting sales and productivity of formal sector firms, and hence their exports performance.

Additionally, tax policy seems to be exerting a negative impact on the likelihood of becoming an exporter. Indeed, Egypt lags behind in the ease of paying taxes, with a global ranking of 151, and ranks of 18 and 35 among MENA and lower middle-income countries subgroups respectively. According to the Doing Business Reports, Egyptian firms make 29 tax payments a year, spend 392 hours a year filing, preparing and paying taxes, and pay total taxes amounting to 45% of profit.

Finally, access to finance and resource constraints can limit the sustainability of the firms' international activity and force exit from the exports market. Indeed, El Said et al. (2015) found a significantly positive impact of dealing with banks and having banking facilities on the probability of exporting and that of exporting to more than one destination. Thus, wider and more efficient financial services are likely to increase exports performance.

Competitive markets and transparent regulations are needed

Enhancing the overall investment climate is a topic of particular interest for developing countries in general and Egypt in particular. Attracting more investments and boosting exports is currently one of the national priorities, and the reforms recently undertaken should enhance the business climate and rebuild domestic and foreign investors' confidence in Egyptian institutions and market. Unfortunately, persistent lack of transparency, unequal access to information and complicated procedures leave domestic private firms underprivileged in comparison to state owned and foreign firms, and remain major obstacles hindering the former to enter and operate, and potentially engage in exporting activities. If Egypt is to encourage exports, serious steps should be taken towards a better climate for local private firms to be able to thrive. Indeed, incentives are an important determinant of firms' export performance. As argued by El Haddad (2016), it is crucial to accentuate equality of opportunity between all market players to improve the economy's competitive environment and hence the production and exports of the industrial sector. Finally, our findings point out the importance of access to finance and a more efficient and more transparent tax policy for a better export performance. In fact, this is particularly important for small and medium enterprises to be able to export and/or increase their exports. In addition to the main barriers affecting the private sector in general, SME's remain largely underprivileged when it comes to access to credit to engage in export activities. SME's are also labor-intensive by nature and encouraging them to produce and export would also promote employment and enhance the social component of the growth process overall.

Further Reading:

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