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Public Enterprise Reform and Privatization in Egypt

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Introduction:

Egypt has always had a strong government and a large public domain. The nature of the land and the imperatives of the irrigation system dictated the importance of central public works and control. The presence of a large public productive sector is a recent phenomenon, however.

The move towards public sector reform (PSR) in Egypt was a long and hesitant process ever since the major nationalization drive in the the early sixties. It dates from the late 1950's when an ambitious industrialization program was initiated. In 40 years, economic and public sector management went through four distinct stages.These stages correspond closely to the evolving political outlook of the country. The first period extended from late 1956 to mid -1961. It was charactrized by tentative government intervention under a free-market orientation. The second stage covered about 13 years (1961-74) in which the public sector was given dominance under a socialist umbrella. The third stage extended from 1974-1989 where the private sector was given a chance to play a parallel albeit increasing role in a more favorable political environment but under de-facto leadership by the Public Sector. The final stage started with the recognition of the severity of the imbalances and the start-up of the first Economic Reform and Structural Adjustment Program (**ERSAP**) in 1991. We shall follow the various attemps of PSR before 1991 in this section and then discuss in more detail public sector reform under ERSAP in section II.

I. Historical Evolution of PSR before 1991

1.1 Development under Free Market:

In its early years, the "1952 revolution" had a favorable attitude towards local industrial capitalism. It promulgated a number of laws designed to encour-age new investments and helped the establishment of new ventures through guaranteeing return on shares. Even the large public acquisitions of foreign properties realized after the Suez crisis (1956/57) were carried out within the framewok of a private enterprise economy. The nationalized properties were compensated for, the role of the private sector in the development of the economy continued to be emphasized, and the stock market continued its active operations.

* In this paper we shall deal only with economic public enterprises defined to be those in which public ownership exceeds 50% and are subject to Law 203/1991. Another important body of quasi-government "Economic Associations" providibg community services such as electricity, water and transport services are outside the scope of this study.

Despite this auspicious relationship between the government and local capitalism, Abdel-Nasser arrived in the late fiftees to a conclusion similar to that of his great predecessor "Mohammed Ali Pasha" a century and half earlier. Namely, a major industrialization drive required more consolidation of resources and decision making. The rate of response of the private sector to the industrial targets of the government was slow. Total industrial investments for both private and public sectros did not exceed L.E. 9-10 million per annum (about US$ 25.0 million) during the period 1952-57.

In the mean time, a wave of Egyptianzation and nationalization of foreign assets following the Suez crisis of 1956 allowed the Government for the first time to control a major segmnet of the economy. As a result, a more ambitious industrial plan became possible, and the first industrialization program was launched in1957. It was believd that up to 50 million Pounds of industrial investments could be implementd per year. Although more foreign funds were now available form the Federal Republic of Gemany, Japan, and the Soviet Union and the eastern block, there was some resistance from the local industrialists.Their priorities differed from those of the first Five Year Development plan initiated in 1960.

It is to be noted that the predominance given to the private sector during the fifties was reflected in the way the public sector was managed. Management of the newly acquired public companies were left to their boards of directors. Their shares were transferred to a holding corporation (The Economic Corporation). Another corporation (El-Nasr) was established to manage public shares in newly established companies.

1.2 Developments under "Arab Socialism":

The fate of the economy was sealed in favor of a public command economy in the wake of another wave of nationalizations in 1960 directed to Belgian interests and two large local banks, namely The Misr Banque and National Bank of Egypt. More "socialist decrees" followed in June and July of 1961. Also, the Alexandria cotton futures' market was closed and all companies dealing with foreign trade were brought under state control. Although the rationale for early nationalizations was not clearly stated it was o bvious the the government perceived these changes as a method to stregthen its hegemony over the economy. Also there was a possible difference in opinion with the major economic conglomerates about investment priorities under the first Five Year Plan. A faint effort to continue control of the newly acquired public enterprises (PEs) using the old holding company format was tried as a third "Misr Corporation" was added to manage Misr Banque Group holdings. Soon it was obvious that these new conglomerates will no able to handle the complex and specialized problems of production, distribution and investments of the various companies. The directives of the development plan and the extreme shortage of foreign exchange and imported requirements made it imperative that economic decisions at the company level be tied to the cabinet bureacracy where decisions regarding

production requirements, raw materials and foreign exchange allocations, and wage and price controls are made.

The original public sector reform was introduced in 1963 where PEs were organized along speciallization lines. Already there was 228 nationalized companies in August of 1963. In the following year, an additional 119 construction companies, 11 foreign trade offices and two oil extraction and distribution companies were nationalized. This plethora of companies were grouped under 38 Public Organizations, affiliated with 13 ministries. the Minister concerned became the effective head of these economic units. Gradually public service regulations regarding wages, incentives, promotions and tenure began to apply to the PEs. Consequently, efficiency and responsiveness suffered.

1.3 Developemnets During the Open Door Policy (1974-89):

After the October War, President Sadat introduced a number of sweeping political and economic reforms that were designed to achieve rapid economic and social development. These moves were simply dupped the "Open Door Policy." A geater role was to be giving to the private sector. Foreign investment was invited under the auspices of a new law (43/1974) that offered guarantees against nationalization along with a generous package of incentives and freedoms from the stringent rules of the socialist era. Nevertheless, the domain of the public sector was left largely intact. A private sector was allowed to grow parallel to the existing public domain. There is evidence that the contribution of the PS to national income grew during the seventies and first half of the eighties. There was no desire to sell any public assets. Managers of state run enterprises and some politicians and bureaucrats fought strongly against any move to sell public enterprises. In addition, new PE investments continued unabated. Efforts to restrict their investments to renovations and rehabilitation were easily frustrated. Public enterprise investments grew by 168.1% from L.E.1823 million in FY1981/82 to L.E. 4888 million in FY 1990/91.

In addition, the losses of these companies continued to be covered from the state budget. In addition PEs' borrowing, guaranteed by the state, made up a large percentage of public banks' portfolio. They continued to receive privileged treatment with actual monopoly in many spheres. These included a part of the export and import trade, the production of some essential goods and vitrtual dominance in electricity production and distribution, and inland transport. A system to "rationalize" imports introduced in 1984 brought back bureaucratic dominance even on the private sector. It was not until budget deficit and foreign debt burden began to be unsupportable around 1986 that a national debate was started to sell part of the PEs especially those that were running losses or were not used economically. This early debate was rather inconclusive, however. PE investments were reduced temporarily in FY 1988/89 to L.E. 3525, (a 28.6% reduction) but then were allowed to increase until FY 1990/91.

It can be safely said that the Government did not change its mind on this matter until the severe foreign indebtness crisis necessitated designing a comprehensive structural adjustment program in 1990.

Perhaps the only positive development was realized in the domain of employment, productivity and wages. As the private sector began to play a larger role in the economy many PE began to feel the pressure of competiton on both the input utilization and output marketing spheres. New private firms baegan paying higher wages, and were able to offer better products and services. They were also using modern techniques and enjoying high productivity. Some PE were able to face the new challenges of the open door policy while other lagged behind. On the whole employment in the productive public sectro hardly grew during the eighties as the individual PEs were not obliged to higher new gradutes. The number of PE employees increased by only 2% in ten years (from 1,307,000 to 1,330,000) resulting in substatial increase in productivity and wages. The average wage in all PEs grew from L.E.1958.7 to 5142 an increase of 162.5%. By contrast the civil service in central and local governments continued to overstaffed. It absorbed a large number of new entrants to the labor market. Total employment in this sector grew from 2,285,000 in 1981/82 to 3,762,000 in 1991/92, an increase of 165%, definitely a staggering increase of an already bloated bureaucracy.

On the other hand, the banking and financial services sector adapted well to free market forces. In the span of a few years it transformed from a lethargic oligopoly of 4 state commercial banks to a vibrant sector of close to forty banks and braches of foreign banks. In addition, the increased convertability of the Egyptian pound and high savings fueled by remittances from abroad made the protential profitabilty of banks very high. This trend continued in the eighties despite a slower growth rate in the productive sectors. Average money wages in the financial PEs grew by 176.4% between 1981/82 and 1991/92 from L.E.3230 to 8929, which is 74% higher than the average wage in all types of PEs (L.E. 5142 per worker in FY1991/92).

II. Public Sector Reform and Privitization under ERSAP

2.1 The size and domain of Public Sector in Egypt:

In Egypt today there is about 314 PE's whose total book-value exceeds L.E. 88 billion (US $ 26.0 billion). The actual market value is much higher than this figure as some of these companies own prime real estate and have high asset replacement value. As going concerns, some are highly profitable. On average, however, the rate of return on value of assets hovered around 2.5%. Total sector profits were around L.E. 2.3 billion in1993. The total value of output reached L.E. 47.5 billion making up 80% of the output of the non-service productive sector. The profit situation was much improved after the freeing of the prices of these companies. In the Mid-eighties, the net profits of all industrial companies was negative.The ratio of losing to profitable industrial PEs was 2:1 in 1987 (78 versus

38). Public enterprises tended to be larger and employment more people than the private sector establishments.They accounted for 58% of all manufacturing employment and 55% of the Finance, Insurance and Real Estate Sector.

2.2 Efforts to Reform the Public Sector:

Since the beginning of 1991 the Government has embarked on a World Bank and IMF assisted economic reform and structural adjustment program (ERSAP) which included many elements relevant to the public sector. First, a new law governing the operations of PEs (Law No. 203/1991) was issued. It stipulated that PEs were to be treated as a private economic unit. The link between the PEs and the state bureaucracy was severed. A new Public Enterpise Office (PEO) was established and attached to the Prime Minister's Office. Later this office was made Part of a new Public Business Sector (PBS) Ministry. Second, the policy of administered social prices was to be phased out. Thus, the raison d'etre of many public enterprises was eliminated. Third, the privatization program was recognized as a vehicle of public policy.

The major policy changes regarding the public sector management under ERSAP can be summarized as follows:

2.2.1 The new law organizing the affairs of PEs (law No.203/1991), renamed these companies to Public Business Sector (PBS) Companies, severed their relation to cabinet ministries, and regrouped the 314 production and service companies (now called affliated companies, ACs) under 17 holding companies (HCs). These changes were more than name-giving. The new PBS companies are now considered private entities owned by the government. They are not to enjoy any favorable treatment or to be burdened by special obligations.They are controlled by the Minister for PBS.

2.2.2 Affiliated companies were instructed to operate economically and to seek maximum return on equity. Similarly, HCs were advised to maximize the value of its financial portfolio and the return on its investments. They were forbidden from extending any direct or indirect financial support to the affliated companies (ACs) except within a financial restructuring program. Such a program should depend on the strategic viability of the company. Unviable projects should be discarded. Financial balance in individual ACs can be achieved largely through increasing their capital by the parent HC. In exceptional cases HCs may extend loans or loan guarantees.

2.2.3 PEs were to be treated like any other private economic unit in terms of access to credit. They were separated from the budget both in terms of investment financing and public credit guarantees. The Central Bank of Egypt instructed all banks to unify the credit ceiling for any customer whether public or private to 25% of the bank's capital and reserves. As the credit to many PEs exceeded this limit,

the banks were asked to reduce their indebtedness (and to increase banks' equity base). This in effect meant a moratorium on new bank lending to many PEs.

2.2.4 The PEO gave extensive attention to the problem of PE indebtness to the banking sector. This problem had reached critical levels. In mid-1992 the total debt of the 300 odd ACs was estimated at 53 billion Eg. Pounds or 63% of the book value of these companies. (The actual market value of these companies may be twice as high thus reducing the percentage of debt by half). This large debt was doubly burdensome due to the high interest rates charged by the banks which reached in some cases 24% p.a., although the average rate was roughly 16%. In view of this situatuion the HCs were instructed to negotiate with creditors for loan rescheduling. The PEO emphasized, however, that a more comrehensive settlemnt with the government should be sought in which a healthy part of the debt to public banks is written off. Some of this debt was incurred originally because the treasurary did not contribute sufficiently to the investment plans of the ACs. Also some PEs are owed substantial sums by the government. In such cases triangular arrangements between the PEs, banks, and the treasurary may be arranged. Also debt/equity swaps are encouraged.

III. The philosophy and acceptance of the privatization program:

The debate around the merits and viability of the privatization program still smolders in Egypt. Some opinion leaders view it as a panacea for many of the financial and economic woes of facing the PEs (liquidity problems, low productivity, backward production techniques, overstaffing, predominant corruption..). Others favored privatization as a vehicle for increasing the base of ownership along lines similar to Mrs. Thatcher's credo of popular capitalism, while yet a large segment of the public opinion remains apprehensive and suspicious of the implications of the program. Since becoming operational, the PEO has had to face a high degree of prejudice and resistance against the concept of privatization. Even the Arabic word selected to describe the process of transferring ownership to private hands was unfamiliar and cumbersome (*Khaskhassa*, from the noun *Khass* or private). The early attempt (Feb.1993) to sell companies en-block through closed tender raised various outcries as to transparency and fair dealing. In addition as some profitable concerns were offered for sale some writers complained "*Why are we selling the crown jewels?!*" As some of these offers were foreign operated hotels that were turning-in hansome profits, the question arose "*Aren't we privatizing already privatized assets?*" During 1992-93 the government was successful in selling, mostly through public auction of more than 2000 small agri-industry projects owned by the various governorates and local authorities. The sale of these projects was speedy and some what trouble free as many of these projects were profitable with market proven records. Also the assets in the dorm of land , cattle, or machinary

were in high demand. Finally the homogeneity of the project and its familiarty made it easy to operate at fair market prices.
The degree of real and perceived obstacles and resistence from labor unions and other vested interests remains high. As it is the case in many other countries public ownership is a source of political power and patronage. This source of power is difficult to let go.

IV. Issues and Problems of Privatization in Egypt :

In the following we shall discuss some of the issues and problems of the privatization program in Egypt.

4.1 Program Orientation:
There seems to be a difference in focus or even orientation of the privatization program between the Government of Egypt and the international aid agencies. While the Government declared objectives emphasize efficiency and financial prudence of existing public sector companies, the international aid agencies take a more ideological stance where dismantling the PBS would mean a wider room for the private sector.
Practical considerations may have had the upper hand after all. Only profitable companies are offered for sale. It is argued that nobody would sell losing companies. In addition, if the HCs are to finance necessary restructuring of delinquent companies they should raise cash outside the treasury.

4.2 Employment Policy Implicationns:
It should be noted that contrary to what is observed elsewhere in Africa where public sector reform was asssociated with a retrenchment program, public policy in Egypt emphasizes the preservation of employment whenever possible. This is largely a function of the fact that the public sector is the largest employer in the economy after the civil service. Government policy is still affected by the socialist principles of the sixties which underlined the right of the people for a productive employment. The high rate of population growth and entry to the labor market (about 2.8% per annum) exceeds the ability of the economy to create jobs (currently at an annual rate of about 1,8 % of the labour force) leading to an aggravated unemployment problem- estimated to be at 16-18% of the work force in 1994. Under this difficult conditions efforts by the managers of some PEs to get rid of short term non-tenured workers led to bloody riots in some industrial centres such as Kafr el-Dawar (Oct. 1994) and other locations.
It is not surprising that the privatization guidelines issued by the Public Entreprise Office (PEO) prevents the new managemnet from laying-off workers for three years after the acquisition.

4.3 <u>The Need for a Clear Legal Framework:</u>

There is also a lot of confusion as to the legality of the privatization process itself.The famous nationalizations of the early sixties were undertaking by special laws, and even the constituttion was changed. The question is raised "Would'nt a reverse legal action be required ?" In addition, it was not clear where the privatization money would go. Will it be used to pay foreign indebtness or cover the deficit of the budget. This misconception was quickly denied, the proceeds would be kept at the Holding Company (HC) level and it can be used to finance other investments or to bail out other comanies in the same group.

4.4 <u>Selection of Companies to be Privatized:</u>

The debate has not been settled as to whether we start with losing or profitable companies. PEO issued a policy statement on divesture procedures in Feb.1993, almost two years of the promulgation of the law allowing sale of PEs' assets. Until then only one major divestiure was achieved through the sale of the public share in a mixed bottling company.

4.5 <u>How to Sell:</u>

Although the officials of the PEO intended to use different methods of privatization, namely sale of assets or shares through the stock market or public auction or tender; employee/management buy outs; lease contracts; and management contracts the outright sale through tender or auction was the method most prominently tried. It was believed that this method will bring in quick results. As the stock market was just coming out of many years of near inactivity it was thought not capable of absorbing the first wave of PE shares. This assessment was proven wrong.

In Feb. 1993, a large number of hotels and industrial companies were offered for sale through tenders. After protracted negotiations only three (Boilers, Pepsi and the Coca Cola bottling companies) were sold *en block* to majority foreign interests. A few hotels were sold. The sale of assets on the other hand may have reflected the desire of the boards of directors of existing public companies to remain entrenched. The sale of PEs in large batches was criticised as they create monopolies and do not realize the government's objective of expanding the base of ownership in the economy. The PEO defended this practice of en block-sale on the ground that they sought a strategic buyer who would be able to renovate and run the company.

A turn around of the stock exchange changed the outlook almost completely. The market was beginning to move after the modernization of its rules introduced by Law 95/1992 began to take effect. In addition, declining interest rates chased funds away from the treasury bills market. The Egyptian stock market showed a high degree of buouancy. The market rose more than 150% in the last five moths. Recent flotations were snapped up. As a result, the PEO

declared a plan to divest of about L.E. 4.5 billions worth of PE shares (almost 6% of the book value of the public sector) over the next two years.

The other privatization method of employee/management buy-out has not been tried yet and not for lack of an old entrepreneurial class. The availability of venture capital seem to be the problem.

Conclusion:

After about four years of soul-searching efforts, it can be said that the privatization program has just started. The divesture of public assets was not an easy affair. Some of the problems encounered (method of sale, beneficiaries, valuation techniques, and the preservation of job opportunities) are similar to those faced in other countries. The debate about the forms of privatization suitable for the conditions of Egypt was the most protracted. It has however been mostly resolved in a practical manner.

In terms of its own objectives, the PEO was not able to achieve except a small fraction of its quantitative objectives. Only 7 cases of privatization were achieved in FY1992/93, and FY1993/94 out of a projected 50 cases. In addition to the three companies mentioned above that were sold *en block,* and perhaps in response to critisim that outright sale does not contribute to widening ownership, the government offered part ownership in four companies. (Misr Chemcals, Misroob, Paints, and Ameria Cement). The experience was heartening. All share flotations were over subscribed.

The high degree of public interest in the privatization program will put additional pressure on the PEO to make its rules of divesture more transparent, and to rely more on "popular capitalism" to make its privatization program successful.