Back from the Brink

Egypt's Economy is Sinking Under Decades of Misrule. Achieving a Better Future Requires a Transformation. Here's the Problem and How to Fix It.

By Tarek Selim

Much has been written about the lack of political liberty during the thirty-year reign of former Egyptian President Hosni Mubarak. But those three decades were also characterized by a lack of economic equity, and deteriorating standards of living. Historically, Egypt has enjoyed a diverse portfolio of resources—plentiful agriculture, hydroelectric power, petroleum and natural gas deposits, and an educated and available labor force. But management of such resources during the Mubarak era was plagued by political favoritism, financial corruption, and a failure to institute innovation-based policies or, for that matter, any system-based policies.

The Mubarak regime touted the relatively high growth rates in Egypt in the years before the 2011 revolution—even after the international recession occurred in 2008, Egypt's GDP still reached a growth rate of 4.1 percent—but it was a mirage. The growth did not trickle down to the middle and lower classes, where social conditions actually worsened. This is what economists call "unbalanced development." As Egypt neared the brink of revolution, more than half of all Egyptians were failing to attain the minimum level of sustained livelihood. Unemployment and inflation rates had continued to hit the poor harshly, with persistent double-digit levels in both economic indicators for more than three consecutive years. Moreover, wages lagged due to high levels of informal workers and child labor, ineffective mapping of skills to work requirements in the labor market, and a legal minimum wage of two Egyptian pounds ($0.35) per day, one-fifth the standard set by the United Nations Development Programme. By the beginning of 2011 it was clear that in Egypt, the rich were getting richer, the poor were getting poorer, and the middle class seemed to be disappearing altogether.

▷ Cotton factory, Mahalla, Sept. 21, 2010. *Shawn Baldwin/ Bloomberg/Getty Images*

Conditions have only worsened since the revolution, including after the election of President Mohammed Morsi in 2012. People had high hopes for any indication of economic recovery, or an announced plan for a new economic system. However, the same economic problems persisted, and some indicators have even worsened. Unemployment remains in double digits, inflation has climbed further still due to the declining value of the Egyptian currency in the international foreign exchange market, and tourism receipts were at record low levels because of severe political instability. Egypt's central bank has made repeated announcements about alarming—and ever decreasing—levels of its reserves, causing financial and economic ratings for Egypt to fall. Also, more critical economic problems emerged after the 2011 revolution, such as fuel shortages and electricity outages, and consequently interruptions in the water supply. In addition, political favoritism continued under Morsi's rule.

It is imperative that Egypt now embarks on a new economic course. The need to rebuild is reason enough for the political factions to put their squabbles aside and unite in the greater interest of the country. Egypt does not need reform; it requires transformational change toward a completely new system. Reforming a system that has failed will not work. Understandably, many Egyptians from the political, social, and economic spheres are calling for reform, but the January 25 revolution clearly highlighted a system failure in the old regime. Thus, there must be new methods of governance, economic management, and political order, based on the principles of accountability and transparency.

What is needed is a bottom-up approach in accordance with the theories of Michael E. Porter of Harvard University. This would start with an examination of Egypt's economic structure, and an analysis of past performance in the various sectors. In the belief that macro-economic management is critical for economic development, the model would then construct a new system based on a vision and plan for a brighter economic future. Porter's method is based on looking at the "critical forces" that govern the sectoral structure of the economy. It builds on the market mechanism (micro-economy) yet does not deny the importance of macro-economic management through effective government regulation of such markets. Porter's sufficiency condition to the achievement of both economic prosperity and social equity simultaneously is to look at the situation on the ground—not only on paper—and to cultivate the forces of the market with efficiency-driven government regulation mechanisms to dictate growth and innovation outcomes, and not vice versa.

Agriculture, Industry, and Services

The central role of agriculture in Egypt's political, economic, and cultural heritage dates back to ancient times. Modern Egyptians remain faithful to agrarian traditions.

In recent years, the agriculture sector has achieved steady growth rates of 3 to 4 percent per year. Yet, the sector continues to decline as an overall percentage of GDP. Agriculture, while employing 32 percent of Egypt's labor force, contributes only 13 percent of GDP.

The agriculture sector is afflicted by numerous problems. It currently behaves according to the "low cost-low quality output trap" hypothesis. Land holdings are relatively small per investor, which works against economies of scale. Thus, the sector utilizes reduced expenditure measures to attain target profit margins, and this has been happening without enough technological mechanization due to a lack of funds in the sector. And consequently, the forces of low cost, low quality, and low output characterize the sector. But perhaps the most pressing problem is low labor productivity, as measured by international benchmarks as well as against other domestic sectors. Many factors contribute to the problem. One of them is the sheer size of Egypt's homogeneous labor force (nearly seven million workers with similar skills, work ethics, and family culture). Another reason is the sector's relative low wages, which are lagging behind the already low wage level in the Egyptian economy. This is a result of low levels of agricultural education and training, as well as severe land fragmentation, the subdivision of land parcels that hinders efficiency and productivity.

Another problem for the sector is inefficient water use. Low levels of investment in infrastructure, an old and inconsistent legal framework, and user subsidies have plagued Egypt's water system. The sector experiences decreasing returns to scale given the high saturation of land—with farmsteads as well as real estate developments—in areas in close proximity to water sources notably the Nile River. Land reclamation for agricultural purposes seems to be the only means for so-called "horizontal land expansion"—in either direction from the Nile—but the high cost of reclaimed land, driven by competition from other sectors, poses a challenge.

Industry contributes to about 35 percent of Egypt's GDP and to nearly one-fifth of its growth rate. About 17 percent of the labor force is employed in this sector. While the industrial sector does enjoy a higher labor productivity level compared to other Egyptian economic sectors, it nonetheless suffers from low labor productivity levels as measured against international benchmarks.

Low labor quality is a major problem, whether we are talking about skilled or unskilled workers. The reasons for this include Egypt's poor overall educational system, the lack of practical training for skilled and unskilled workers, and an inadequate matching of skills with the needs of employers. Another problem is that industry faces technical constraints due to severely low levels of innovation. Egypt spends little on research and development (R&D), and there is an absence of the type of university-industry collaboration in R&D that is necessary for industrial competitiveness. Egypt's dependency on imported technologies is another obstacle to industrial development. Factors such as ministerial decrees, sudden policy shifts, lack of transparency, and corruption combine to discourage technological upgrading and industrial innovation.

A fundamental problem hindering industrial development is state control and influence over the sector. The government's power over the sector began back in 1961 during an era of nationalization under Egypt's then leader, Gamal Abdel Nasser, but has maintained its influence to this day, despite many attempts for privatization. Nasser's endeavors in industrialization were based on the public sector with economies of scale, given the size of the Egyptian population at the time. It worked well for at least a decade, but was not sustainable due to a lack of technological progress and over-employment in public sector industries, such as textiles, iron and steel, home appliances, scientific research, and pharmaceuticals. Anwar Sadat's open door policies in the 1970s were mostly geared towards open trade in consumption, rather than creating new industrial markets locally.

The efforts at privatization undertaken by the Mubarak regime resulted in crony capitalism—monopolies in industrial enterprises shifted from the state to a private sector with close political ties to Mubarak's ruling National Democratic Party. The powerful monopolies of these tycoons, combined with historically weak supply-chain infrastructure, undermined any potential contribution to innovation from the private sector. Factors such as political favoritism, high levels of country risk, and a lack of information transparency encouraged the private sector to pursue short-term gains at the expense of long-term prospects. Consequently, local innovation has been geared toward reducing expenditures on total delivered cost reaching the consumer. Yet it generally overlooked the potential of high quality technological attributes for industrial production, the latter being a risky strategy due to insufficient local demand for high-priced industrial goods.

Egypt's services sector contributes to 57 percent of the country's GDP. The sector is dominated by three services, all of which are foreign dependent: tourism, which relies on visitors from abroad; telecom, which is largely foreign owned and depends on outside technology; and financial services, which rely on technology outside Egypt's borders.

Foreign dependency is a potential problem because the sector's investment funds and proceeds are not locally based. Nobel laureate Robert Solow's growth theory argument states that local technological innovation, through capital investments, is the key to sustainable development. When such funds are foreign dependent, a lack of sustainability could be a problem.

Yet, foreign dependency provides a host of direct benefits and positive externalities to the economy as well. For example, the services sector employs more than half of the Egyptian work force, making it the country's leading job market. Services contribute to neutralizing the trade deficit via net exports. The sector is a main source of Foreign Direct Investment (FDI), and an engine for driving business generally. And it is a means for spreading technology, efficiency, quality, and growth to other sectors of the economy.

In assessing Egypt's economic challenges, it is essential to focus on the key structural characteristics. The agriculture sector behaves on the basis of the traditional comparative advantage of low cost and low output driven by subsidies for the benefit of food security. This persistent policy has been at the expense of almost everything else. The sector is characterized by low mechanization, land fragmentation, weak technological externality, quality problems, and decreasing returns to scale. The industrial sector, for its part, is seen as the main victim of crony capitalism. Corruption and political ties have greatly outweighed any industrial efficiency or technological gains in this sector. Yet, it did achieve, albeit in a monopolistic context, economies of scale in key industries, such as steel, cement, and food processing. The services sector is considered to be the most diverse, the most differentiated, and the least monopolistic. It operates in the context of foreign dependency yet has huge potential in terms of follow-on benefits for other sectors of the economy.

A New Economic Vision

Competitive economies tend to produce higher levels of income for their citizens. Egypt, however, has not fared well in competitiveness studies. The World Economic Forum's Global Competitiveness Index (GCI) defines competitiveness as the set of institutions, policies, and factors that determine the level of productivity of a certain country relative to its peers. The level of productivity, in turn, sets the sustainable level of prosperity that can be earned by any economy. The productivity level also determines the rates of return obtained by investments (physical, human, and technological). Because the rates of return are the fundamental drivers of the growth rates of an economy, a more competitive economy is one that is likely to grow faster in the medium- and long-term.

Egypt's GCI has been weak and erratic. It ranked eighty-one out of 139 countries in 2010 on the eve of the revolution, down from seventy the preceding year. The fall in rank indicated the persistence of an inefficient and stagnant economic system. The economy experienced an artificial growth trajectory due to the high financial profitability of a relatively few elite enterprises—there was though a lack of notable local innovation and no trickle-down (spillover) effects. This meant such economic activities had little impact on the masses.

The relatively high reported GDP growth rate in 2010 certainly did not reflect national productivity. Once again, growth rates alone turned out to be a poor indicator of economic development. Egypt's lowest competitiveness rankings have been in the areas of corruption, macroeconomic environment, R&D spending, effectiveness of higher education and training, and labor market efficiency (the latter category scoring next to last in the rankings of all nations). Egypt received its lowest rankings in precisely the areas required for any sustainable level of competitiveness.

A brighter economic future is within Egypt's grasp. There are a variety of solutions to some of the basic problems. For example, significant "scale and stretch" opportunities exist that can help the agricultural sector reach another level. There is strong potential for Egypt to expand into new markets, such as food processing and retail food chains and franchising. Better education and skills upgrading can help the sector's abundance of low-cost labor achieve a value-added advantage. Egyptian farmers stand to make substantial gains by moving from traditional to mechanized agricultural techniques. Egypt has an opportunity to exploit its comparative strengths, including favorable weather conditions that allow for year-round cultivation, and the potential that land reclamation could increase crop outputs by 3.5 percent per year, thus exceeding its own population growth.

Egypt's water subsidy has historically encouraged over-consumption. Coupled with a fixed Nile-basin water quota, Egypt now needs to reconsider its water policy. Re-allocating water subsidies and introducing fair water pricing formula to eliminate excess water demand is necessary. This will create an "equilibrium water usage" in the country, rather than over-consumption of a potentially scarce resource. Egypt must reach satisfactory understandings on water use with Africa's Nile Basin countries, and partner with them to maximize agricultural efficiency. The goal should be growth in agriculture that will exceed growth in the population rate, an essential factor for achieving food security.

In order to reverse Egypt's poor industrial performance, improving standards of quality, expanding R&D, creating university-industry partnerships, and upgrading the supply chain are all important pillars for success. Incentives to deepen existing investments and create new innovative industrial ventures are equally important. Another step is enforcing anti-monopolistic fair pricing practices. Egypt may have much to learn from the economies of the so-called BRICS nations—Brazil, Russia, India, China, and South Africa—in terms of their industrial capacity, economies of scale and stretch, "Creating Shared Value" projects, industrial innovation, and locally-based multinational enterprises. The concept of Creating Shared Value using private investment for public interest, first introduced by Michael E. Porter and his colleague Mark R. Kramer, has been very successful in the BRICS economies. Egypt can borrow from such experiences, such as profit-seeking investments tackling public goods and services related to environmental pollution, infrastructure development, education scholarships, health-based research, and other national-based targets.

The future of Egyptian services could be quite promising if certain criteria are met. Exploiting the advantages of foreign dependency will be one of the key practices. For example, the foreign demand dependence in tourism can be turned into an intangible asset in the form of branding Egypt on a global scale. Dependency on foreign financing can be turned to an advantage by fostering partnerships with local entrepreneurs, and shifting FDI from capital-intensive to labor-intensive enterprises to reduce unemployment. Additionally, Egypt should promote value-added investments in the services sector, with the aim of yielding significant positive externality to other sectors of the economy.

To truly move forward, however, Egypt must adopt a vision to create an efficiency-driven competitive market in the short to medium term, and an innovation-driven society in the long term. Such a vision must be pursued in keeping with the January 25 revolution's demands for equity and economic justice, more jobs and higher living standards. The economy needs to gradually shift from the extreme neo-classical liberal approach of the Mubarak era to a welfare state that also provides an open environment for investment and entrepreneurship. Three stages of implementation are required:

Short-Term Recommendations

The first stage—over a span of one to two years—is immediate intervention, with the objective of establishing the prerequisites for a systemized economy. To begin with, political unrest must cease or be reduced significantly. Public management systems must be restructured, and training programs to upgrade labor productivity upgraded. Transparency-driven regulations and mechanisms must be enacted to reduce corruption. Also, the application of "labor matching schemes" to operational performance in public enterprises should be mandatory, such that efficiency is the core criteria for job security. Public jobs must be mapped to the education skills required for work tasks, and in essence the whole labor market and the education sector should be mapped together in order to feed each other with operational skills, knowledge, and talent. Consideration should be given to revising the minimum wage structure to adjust for inflation, and index it to achieved educational levels.

Medium-Term Recommendations
The second and most challenging stage—over a span of three to five years—should be aimed at achieving an efficiency-driven economy with distributional equity among the masses. This stage requires transformational changes in the structure of the Egyptian economy, starting with the establishment of a national planning commission. Regulations must be implemented to enforce local quality standards in line with regional competition. An effort must be undertaken to radically improve and update the educational system across all levels, which would abandon a pedagogy based on rote memorization in favor of one that inculcates critical thinking skills. Meanwhile, a private education system as an alternative to free tertiary education should be created with links to public R&D and industry practice.

The Egyptian government should undertake a major overhaul of national infrastructure in this stage; among the aims would be tackling agricultural land fragmentation, improving supply chains for industry, and maximizing positive externalities in services. Policymakers should promote the concept of Creating Shared Value, thus igniting investment through an understanding of the interdependence of business and society. This would require the enactment of national mechanisms for cost-benefit analysis using economic and social-environmental evaluation of new investments, and abandoning sole reliance on financial cost-benefit assessments. In other words, economic value-added should receive priority in evaluating financial projects even under private sector investment. The government should allow subsidies for essential goods only when they remain in line with national competitiveness goals. It is no use for citizens to receive entitlements of subsidized goods and services if such goods and services fail to function properly. This doctrine concerning economic subsidies, espoused by the Indian economist Amartya Sen, must be implemented to have a sustainable growth path based on efficiency.

Long-Term Recommendations
The third stage, spanning five to twenty years, is aimed at creating a sustainable, innovation-driven society based on international standards. Numerous critical elements must be achieved. One of them is a cultural transformation to develop a world-class educational system—not unlike the enlightenment that occurred in Egypt through the educational expeditions to Europe during the reign of Mohammed Ali. Another vital element is to spend a minimum of 5 percent of GDP (compared to the current expenditure of 0.5 percent) on R&D, with strong connections to the agriculture, industrial, and services sectors. Egypt must also undergo a radical shift toward an institutional culture as it relates to work ethics, corruption, and information transparency; a policy of zero-tolerance for corruption should be

pursued. Finally, policymakers should seek to make Egypt an entrepreneurship hub for the region by promoting local and regional investments through a differentiated competitive advantage. Tourism is an obvious but by no means the only area ripe for a "branding Egypt" strategy.

Egypt needs a new manifesto, as demanded by the people, in the slogan Bread, Freedom, and Social Justice! Egyptians can unite around such a vision, whatever their ideology or religion, to achieve the dream of a better future. Leaders and policymakers must create the environment for making this happen.