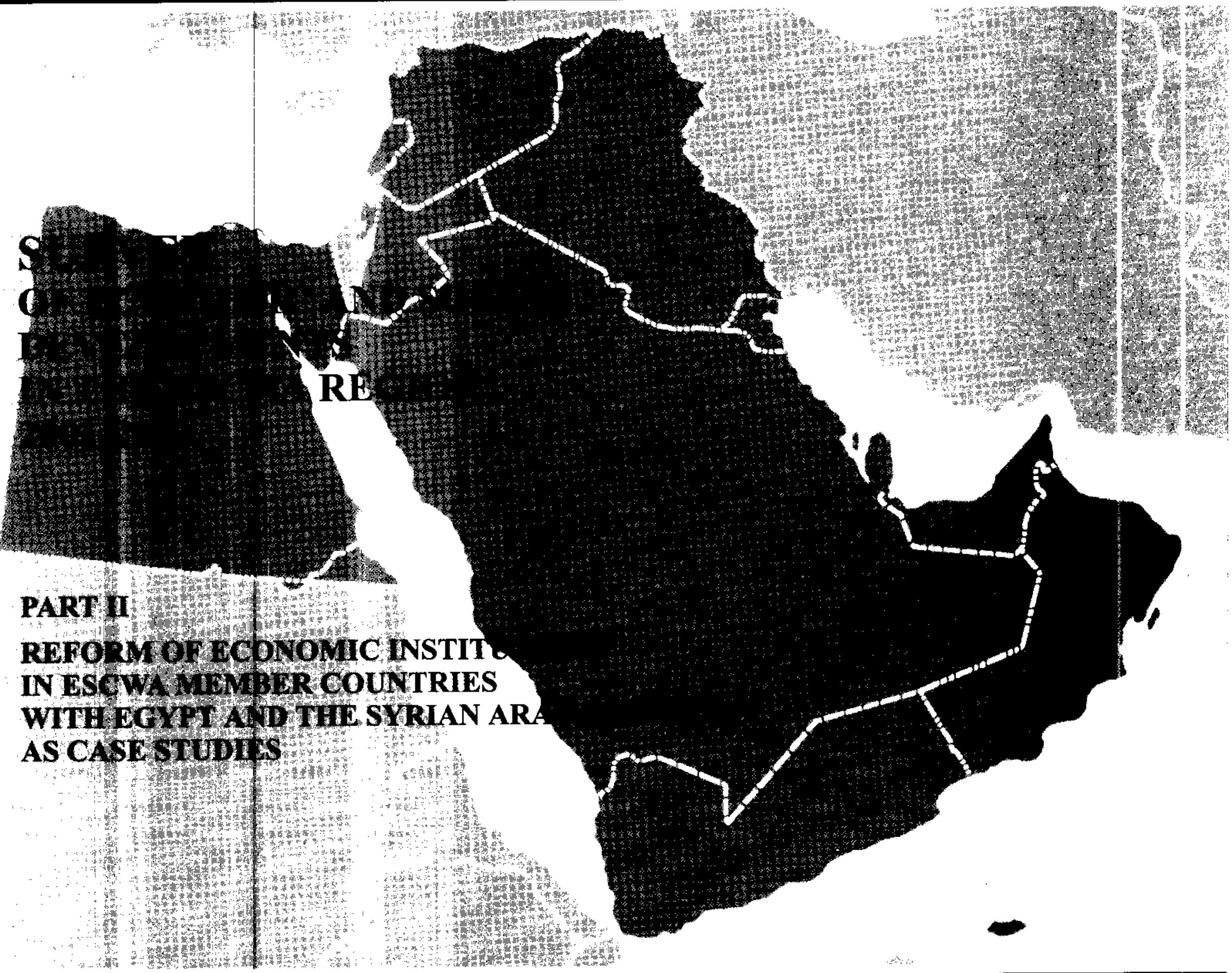
# ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA



PART II

REFORM OF ECONOMIC INSTITU
IN ESCWA MEMBER COUNTRIES
WITH EGYPT AND THE SYRIAN ARA
AS CASE STUDIES

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ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA

# SURVEY
# OF ECONOMIC AND SOCIAL DEVELOPMENTS IN THE ESCWA REGION 2001-2002

## PART II

## REFORM OF ECONOMIC INSTITUTIONS IN ESCWA MEMBER COUNTRIES WITH EGYPT AND THE SYRIAN ARAB REPUBLIC AS CASE STUDIES

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## Preface

This study was prepared by the Economic and Social Commission for Western Asia (ESCWA) and represents one of the activities completed under the programme of work of the Economic Development Issues and Policies Division for the biennium 2001-2002.

During the preparation of this publication, ESCWA sought the assistance of Ashraf Shamseldin for the case study on Egypt, and of Fouad Al-Sayed for the case study on the Syrian Arab Republic. Special thanks go to both of them for their valuable contributions.

## CONTENTS

## ABBREVIATIONS

| | |
|---|---|
| ADB | Asian Development Bank |
| AFTA | Arab Free Trade Area |
| BCCI | Bank of Credit and Commerce International |
| BOOT | build-own-operate-transfer |
| BOT | build-operate-transfer |
| CIPE | Center for International Private Enterprises |
| COMESA | Common Market for Eastern and Southern Africa |
| CPC | Commission for Protection of the Competition |
| EBRD | European Bank for Reconstruction and Development |
| ECES | Egyptian Center for Economic Studies |
| ESA | employee shareholder association |
| EU | European Union |
| FDI | foreign direct investment |
| GCR | Global Competitiveness Report |
| GDP | gross domestic product |
| HIID | Harvard Institute for International Development |
| ICRG | International Country Risk Guide |
| ICT | information and communications technology |
| IMF | International Monetary Fund |
| IPR | intellectual property rights |
| IRIS Center | Center on Institutional Reform and the Informal Sector |
| LE | Egyptian pound |
| MIGA | Multilateral Investment Guarantee Agency |
| NGO | non-governmental organization |
| OECD | Organization for Economic Cooperation and Development |
| PE | public enterprises |
| PEO | Public Enterprise Office |
| R and D | research and development |
| ROSC | Report on the Observance of Standards and Codes |
| SME | small and medium-sized enterprises |
| SOE | State-owned enterprise |
| STI | science, technology and innovation |
| TI | Transparency International |
| TRIP | Trade-Related Intellectual Property Right |
| UNCTAD | United Nations Conference on Trade and Development |
| WIPO | World Intellectual Property Organization |
| WTO | World Trade Organization |

References to dollars ($) are to United States dollars, unless otherwise stated.

**Executive summary**

Both the classical and neoclassical economic growth theories are unable to adequately explain why many developing countries, including ESCWA members, have failed to achieve rapid economic growth.[1] This has prompted economists to advance the neo-institutional theory to account for the sluggish economic growth. While neoclassical economic theory attributes economic growth and development solely to the factors of production and disregards the role of the institutional framework, neo-institutional theory maintains that economic institutions are prerequisites for economic growth and development and must focus on the following four issues:

(a) Protection of property rights, thereby encouraging long-term investments by the private sector; promoting the inflow of foreign direct investment (FDI), which increases productivity, competitiveness and exports; and enhancing the image of the State through its commitment to safeguarding private property;

(b) Contract laws that are respected and enforced, including those signed by the State, thereby encouraging the private sector with regard to investment decisions; offering an enabling environment for business transactions and the exchange of properties within the market; and boosting the credibility in the economic policies of the State through its role in formulating and implementing clear and transparent contracts;

(c) Corporate governance to establish rules that govern the relationship between investors and corporate management with the aim of protecting the rights of small investors in particular, and that govern the operations of private firms with the aim of preventing corruption;

(d) Competition laws to enhance competition of domestic products in local and international markets, thereby promoting efficiency, reducing prices, improving quality and encouraging the efficient allocation of resources by preventing monopolies.

Institutions vary according to the strategy they serve. The institutional set up that promotes the command economy cannot serve the market economy. Similarly, the set of institutions that is appropriate for one country can prove inefficient or inadequate when applied to another country that differs in terms of socio-economic development, cultural orientation and technological level. Institutional changes therefore arise as a result of changes in economic policy, social transformation and/or technological advances. Economic policy that promotes liberalization and openness requires a set of institutions that supports the market economy and promotes competition. Equally, an institutional set up that promotes equal opportunities and decentralization is characteristic of a country with high literacy rates, proactive non-governmental organizations (NGOs) and the full participation of women in the workplace. Within the context of technological development, advances in science, technology and innovation (STI) require the formulation of institutions that protect property rights, particularly intellectual property rights (IPRs).

In general, the institutional change is incremental and must respond to the natural evolution of society. In developed countries, the evolution of institutions has progressed gradually over the course of several centuries. However, in developing countries and in those countries that have suffered from civil wars and revolutions, the rate of institutional change has been measured in decades. In many cases, this comparatively rapid evolution has created a lack of harmony between those institutions that have been imported from developed countries and the local and informal institutions that reflect domestic social norms and cultural beliefs.

In the ESCWA region, the institutional reform over the past decade has generally been slow and limited. The focus of the economic reform has been on stabilizing macroeconomic policies. However, in some countries, including Egypt, Jordan, the Syrian Arab Republic and Yemen, progress has been made in reforming the institutional set up. This survey draws on the experiences of two ESCWA member countries,

[1] M.N. Baily, *The Importance of Institutions in Long Term Growth*, Center on Institutional Reform and the Informal Sector (IRIS Center), Working Paper No. 135, September 1994.

namely, Egypt and the Syrian Arab Republic. These two countries were chosen to compare the impact of institutional reforms in a country that implemented a programme of economic and institutional reform, as in Egypt, with a country that introduced only limited institutional reform and gradual economic policy reform, as in the Syrian Arab Republic.

In Egypt, an adequate and efficient institutional framework has been formulated as part of the overall economic reforms. The principal objectives have been realized in a number of areas, namely, investment laws and regulations; privatization of State-owned enterprises (SOEs); decentralization; stock market institutions, including the reform of commercial arbitration; banking institutions with the introduction of new laws in banking, foreign exchange and capital markets; and corporate governance through the introduction of company law.

However, establishing new market institutions has been relatively slow in Egypt. More progress is needed, particularly in the areas of contract law and competition, which are vital for building a market economy. While the Government in Egypt has formulated a draft competition law to be approved by Parliament, these constraints remain an impediment to private sector participation, particularly with regard to attracting FDI. In Egypt, as in many developing countries, there is a need to formulate and implement adequate laws and regulations, and to create effective enforcement mechanisms.

In the Syrian Arab Republic, economic reform has been slow. The strategy of economic reform aims at enhancing efficiency and not the transfer of ownership. The experience of reform in the Syrian Arab Republic therefore differs from that in many developing countries, including other ESCWA members, where privatization has been at the forefront of economic reform. Moreover, the reform in the Syrian Arab Republic has been implemented gradually and formulated domestically without the participation of the World Bank or the International Monetary Fund (IMF).

The Government in the Syrian Arab Republic is not considering privatization as a major objective in its sponsored reform. Rather, the aim is to expand the role of the public sector enterprises and make them more efficient. The institutional reform in the past few years has concentrated on the introduction of new laws on investment, banking and foreign trade. It is built on the cooperation and complementarities between the public and the private sectors within a more competitive environment. However, there is a need for reform in the public sector that must focus on transparency and accountability; and the operations of SOEs must be exposed to more competition in the marketplace.

Finally, while the need for institutions is global, the applied institutions differ from one country to the next. Moreover, they can even differ, within the same country, from one stage of economic and social development to another. Institutional reform is not an end in itself. Rather, it is meant to ensure that economic and political strategies operate smoothly and efficiently. It is a need and not merely an objective. A lack of institutions brings chaos, confusion and anarchy.

# INTRODUCTION

The main objective of this study is to analyse economic institutions and examine their role in transforming the economies of developing countries. The analysis encompasses a review of the definitions, concepts, types and objectives of these institutions. Within this context, a number of related issues are tackled and further analysed, including property rights, contract laws, competition laws, corporate governance and the impact of corruption on institutional reform.

The ultimate aim of economic institutions is to promote economic growth and development, which the command economy has failed to achieve adequately for developing countries. This requires proactive involvement by these institutions on the following fronts: (a) to support the market economy; (b) to promote competition; (c) to reduce transaction costs; (d) to protect property rights; (e) to enforce contracts; (f) to provide information aimed at enhancing transparency; and (g) to promote the participation of the private sector.

The success of institutional reform hinges on several socio-economic factors, including the status of human development, technological advances, cultural orientation and status of economic development. Moreover, there is a close link between formal and informal institutions. The combination of the two comprises the institutional framework. The impact of the informal institutions is important because it includes the social norms of the society, which has accumulated over a long period of time, and because it is more resilient to change. Informal institutions are important in the rural society, particularly in developing countries. Lack of compatibility between the formal and informal institutions can create obstacles to the institutional reform in developing countries by creating social resistance to change the informal rules and regulations.

In the ESCWA region, institutional reforms have been protracted. This is largely attributed to the slow pace and gradual implementation of economic reform. Only three ESCWA members have carried out a programme of economic reform in cooperation and consultation with IMF and the World Bank. These three are Egypt, Jordan and Yemen. The rest are implementing gradual and relatively limited reforms. Furthermore, only Egypt and Jordan have formulated draft competition laws, the respective legislative authorities of those countries have not promulgated them. Additionally, contract laws, which were established in the pre-globalized era, have not been reformed to better serve the current world economic environment.

This study consists of the following five chapters: chapter I, which deals with the definitions, concepts, types and objectives of institutions; chapter II, which analyses those institutions that have a direct impact on the market economy and that are the bases for economic reform in developing countries; chapters III and IV, which deal with the case studies of Egypt and the Syrian Arab Republic respectively; and chapter V, which presents a set of policy recommendations for institutional and economic reform.

# I. INSTITUTIONS: DEFINITION, CONCEPT, TYPES AND OBJECTIVES

## A. DEFINITION

There are several definitions of institutions. According to North, institutions are "the rules of the game in a society".[2] Moreover, they represent "a guide to human interaction".[3] Institutions are both formal and informal. The formal institutions are the rules and regulations formulated by the political and legislative authorities to define the interaction in society. The informal institutions, on the other hand, include the social and cultural norms and traditions that are transferred from one generation to the next. Together they define "the way the game is played. Organizations are the players".[4]

The role of the institutional framework in the economy is important since it defines the strategy and rules of the economy. The institutions that apply to command economy cannot serve the market economy. Similarly, institutions that are good for one society cannot serve the objectives of another given that institutions are closely linked to social, cultural, demographic and human development that vary from one country to another.

Institutional reform is part of the evolution and development of society, and is generally an incremental process. Institutional changes are undertaken over time in order to meet the changing needs of society. However, in some cases, the change can be abrupt, particularly in those countries that have suffered from wars and revolutions. In the countries of the former Union of the Soviet Socialist Republics, for instance, the political and economic system collapsed and was replaced by a new system in a matter of a few years. These countries shifted from command economies to market economies, and from one-party oligarchies to multiparty democracies.

Moreover, in the 1990s, a large number of developing countries, including several ESCWA members, shifted from an economic strategy that was oriented towards socialism to a strategy that was more geared towards a market economy. This required the transformation of the institutional framework to better serve the market economy.

Institutional reform is strongly linked to human development and cannot therefore be viewed in isolation from economic and social reforms. Education and training play a vital role in formulating and enforcing adequate and efficient institutions. Moreover, private sector confidence is boosted by "a professional and accountable bureaucracy that can enforce the rules and ensure standards, competition, and property rights".[5] Furthermore, given an equally strong link with respect to social and cultural issues, the set of institutions applied in developed countries cannot work as efficiently in developing countries. There is, therefore, a need for institutional adaptation whenever developing countries import and implement institutions from developed countries. This modifying process is vital since formal institutions can only operate successfully if they are compatible with the prevailing informal institutions.

## B. TYPES OF INSTITUTIONS

Institutions are either formal rules and regulations or informal norms. Formal institutions can be divided into legal, political, economic and social. The following paragraphs highlight the roles played by legal and political institutions.

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[2] D. North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, 1990, p. 3.

[3] Ibid.

[4] D. North, "Institutions and economic change", *Lecture Series No. 12*, Egyptian Center for Economic Studies (ECES), 1998, p. 2.

[5] H.L. Root, "Managing development through institution building", *Occasional Papers No. 12*, Asian Development Bank (ADB), October 1995, p. 7.

### 1. *Legal institutions*

The reform of legal institutions, including the judiciary system, represents the first step in the process of institutional reform. All other institutions are closely linked to the legal and regulatory institutions. There is little investment, particularly private investment, without the protection of law and order. Moreover, private investors cannot make long-term investment decisions without the safeguard of private property. Legal institutions are therefore the catalyst of institutional reform.

Most of the laws and regulations in developing countries were acquired from developed countries or inherited from the colonial period. While some of these laws have been modified or abrogated in developed countries owing to the evolution of economic, social and political conditions, they have largely remained unchanged in developing countries. A further constraint is that these laws were formulated during the period when the State dominated the economic environment with meagre participation from the private sector. They are therefore wholly inadequate in the current market environment that calls for greater economic activity by the private sector. The legal environment in developing countries needs to be changed to serve this new reality. This is particularly relevant since a change in policies alone cannot achieve the purpose of economic transformation into a market economy.

There are a number of major issues with regard to legal institutions in developing countries. Foremost among these are the following:

(a) There are no clear institutions that protect private property;

(b) Financial institutions favour the public sector over the private sector in both credit and exchange rate;

(c) Investment laws and regulations are devoted to serve the public sector, thereby discriminating against the private sector;

(d) Accountability is weak, which encourages the spread of corruption among officials in the public sector;

(e) Monitoring institutions are inadequate and lead to the accumulation of losses by SOEs, thereby contributing to lower growth;

(f) Competition among various public sector enterprises over resources and political influence hinders economic efficiency, thereby leading to lower productivity and sluggish economic growth.

Additionally, the judicial system is weak, slow and inefficient in many developing countries, including ESCWA members. There is an absence of specialized courts, particularly commercial courts. Moreover, court proceedings are generally protracted, which causes delays, prolongs disputes and adds unnecessary costs. These delays can be attributed to an insufficient number of judges or courts, or to purely bureaucratic obstacles.

Within the context of commercial disputes in developing countries, there are four key issues, namely: (a) commercial disputes are handled by ordinary and criminal courts that are not fully versed in commercial law, thereby adding further delays; (b) there are an insufficient number of judges specialized in commercial disputes, particularly those disputes between local and international enterprises; (c) judges are appointed by the State and therefore can be prone to political influence; and (d) judges do not engage in frequent and continuous training, particularly in areas of international codes and commercial regulations.

## 2. *Political institutions*

Political institutions are part of the institutional set up of the State. They encompass a number of areas, namely, the political system of the State, including the system of Government and the relationship between the Government and the political opposition; the electoral and election rules; and the political parties.

There is a strong link between the political and economic systems. In essence, a one-party system of Government favours a command economy, as evidenced by the political systems in developing countries during the pre-reform period; whereas those countries that pursue an open, multiparty system of Government tend to adopt more liberalized market economies. Moreover, the multiparty system of Government is generally more open in terms of information with regard to policy issues, which is an important factor for the participation of the private sector. It provides predictability and stability in policy matters, thereby encouraging private investment and the inflow of FDI. Moreover, it promotes transparency in the decision-making process since decisions are open for debate among politicians both at the executive and legislative levels.

Despite these clear advantages over the one-party State, there are a number of defects in the multiparty system. Chiefly, there is a comparatively rapid turnover of power between political parties. Rapid changes of Government can endanger political stability, which is at the heart of economic stability. Moreover, the implementation of economic reform can be faster in a one-party system, particularly when there are obstructions to policies by the opposition or coalition parties of a multiparty system. Furthermore, during an election year, unpopular but necessary economic measures are more likely to be delayed in a multiparty system, and the party in power can be tempted to use fiscal policy to increase its chances of re-election.[6]

The impact of the political system on monetary policy is equally clear in many developing countries, including ESCWA members. Prior to the implementation of economic reform, the exchange rates of local currencies in many of these countries were administratively set and were generally overvalued. Furthermore, the central banks were limited in their capacity to effectively manage the monetary policy since they were directly controlled by the State. Most of the resources were directed to SOEs, and the banking system was the major source of finance for the fiscal deficit.

## C. OBJECTIVES OF INSTITUTIONS

The principal aims of institutions include the following:

(a) *To promote the establishment of a market economy*

Economic institutions are the rules and regulations that govern successful market economies. They reduce transaction costs, enhance productivity and promote competition, which is the fundamental principle of a market economy. Moreover, they combat corruption by enhancing transparency, and promote the role of the private sector by protecting property rights, enforcing contacts and maintaining law and order. The lack of such institutions has impeded economic growth in developing countries over the past two decades by, *inter alia*, preventing the active participation of the private sector and by discouraging the inflow of FDI. In their aim to transform their economies into market economies, developing countries need to carry out institutional reform to serve the market economy.

(b) *To enhance predictability in economic policies*

The lack of predictability in economic policies represents a major constraint on private investment in developing countries. Sudden policy changes, abrupt changes of Government or a lack of protection with

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[6] A survey of 123 developed and developing countries conducted by the World Bank in 2002 concluded that during an election year, fiscal deficit tends to be higher by approximately 1 per cent of gross domestic product (GDP). *World Development Report 2002*, the World Bank, 2002, p. 103.

regard to property rights generate confusion in the economic environment, thereby discouraging private investment in general and FDI in particular. Institutions that debate policies, protect property rights and seek to maintain law and order can provide assurance to the long-term investment by the private sector, which is vital for long-term economic growth.

(c) *To promote stability in policy issues*

Stability is a key element for promoting private sector investment. Stable macroeconomic policies promote confidence in the economic policies of the Government, thereby encouraging participation by the private sector, including the inflow of FDI. Moreover, stability of macroeconomic policy reduces or even eliminates confusion and chaos, and encourages long-term investment, particularly in technology-related industries.[7]

(d) *To promote transparency*

Transparency is a major factor in promoting trust and confidence in the policies of the State. Promoting transparency enhances the public confidence in the economic programmes of the State, including privatization, thereby reducing resistance to economic change. Moreover, transparency can promote the inflow of private capital, including FDI, through the adequate dissemination of information with regard to policy changes, decision-making policies and economic performance. Information is a valuable tool, and the media can play a major role in enhancing transparency and, consequently, credibility in the policies of the State.

(e) *To reduce transaction costs*

One of the main roles of institutions is to reduce transaction costs, which increases competitiveness. Institutions provide the "structure of exchange that determines the cost of transacting and the cost of transformations".[8] The complexities of international trade make it difficult for buyers and sellers, or exporters and importers to share information about each other and engage in commercial activities. Through trade commissions, chambers of commerce and banking systems, institutions play a key role in providing such information and in assisting in time-saving and cost-cutting transactions.

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[7] In a survey of private entrepreneurs in the Commonwealth of Independent States (CIS), which was conducted by the World Bank in 1997, approximately 80 per cent of those surveyed expressed concern over policy surprises. A. Brunetti, G. Kisunko and B. Weder, *Institutional Obstacles for Doing Business: Data Description and Methodology of a Worldwide Private Sector Survey*, the World Bank, 1997, p. 10.

[8] D. North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, 1990, p. 34.

## II. THE ROLE OF INSTITUTIONS IN ECONOMIC GROWTH

Institutions are an integral part of the market economy. Within the framework of a successful market economy, they play a key role in protecting property rights, enforcing contracts, improving corporate governance, encouraging competition and fighting corruption. Moreover, institutions are "the underlying reasons why some countries have succeeded in generating rapid growth and others have not".[9]

Many economists attribute the slow economic growth in developing countries, including ESCWA members, to the absence of an adequate and enforceable institutional framework. Moreover, low productivity is mainly due to low capital intensity, old technologies and a lack of institutions.[10] Additionally, effective social institutions can "complement the effect of Government institutions in reducing uncertainty and transaction costs, enhancing the efficiency exchange, encouraging specialization, and encouraging investment in ideas, human capital and physical capital".[11] This implies a close relationship between economic growth and both formal and informal institutions.

Economic growth and stability equally hinge on political stability. Private investment, particularly foreign, cannot be attracted to a country characterized by instability, either political or economic. While the nature of the political system is the main factor determining political stability, the existence of institutions represent the vital element in economic stability. The uncertainty with regard to the protection of property and the enforcement of contracts, including those with the State, in addition to frequent State interventions in the marketplace are detrimental to economic stability and hinder economic growth. Moreover, corruption and bureaucracy discourage private sector investment, thereby dampening economic growth.

This chapter provides the salient features of institutional reform and its impact on economic growth, including the changing roles of the State and private sector, the objectives and obstacles.

### A. PROPERTY RIGHTS

#### 1. *Defining property rights*

By definition, a market economy is based on property rights. The private sector cannot participate in economic activities without adequate protection of property rights. Additionally, property rights are closely linked to market prices. The whole concept of the market economy collapses without a price mechanism to drive market transactions and which is "built upon the foundation of a system of property and contract". [12]

The privatization of SOEs has added urgency with regard to the formulation of adequate property rights institutions. Moreover, the issue of property rights is closely linked to another defining pillar of the market economy, namely, the issue of legal contracts.[13] There is therefore a strong link between property rights and the legal and judiciary system since any transfer of property is conducted through the prevailing legal system, and the judiciary system is responsible for the protection of property rights.

#### 2. *The role of the State in protecting property rights*

Property rights can be defined as a legal entitlement to a property, product, patented idea or copyrighted work that is "transferred by voluntary contracts and enforced by the legal system".[14] In general,

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[9] M.N. Baily, *The Importance of Institutions in Long Term Growth*, IRIS Center, Working Paper No. 135, September 1994, p. 4.

[10] A case study of several Latin American countries concluded that the lack of investment was not the only major factor for low productivity in those countries since "if Latin America gets the institutions right and the incentives right, the investment will be available from the world capital markets and companies will train workers as they do in developed countries". Ibid., p. 38.

[11] S. Knack, *Growth and Governance: Measurement and Evidence*, the World Bank, February 2002, p. 1.

[12] D. Ellerman, *Introduction to Property Theory: The Fundamental Theorems*, the World Bank, January 2002, p. 2.

[13] Ibid., p. 8.

[14] Ibid., p. 14.

the legal systems in developing countries do not adequately protect property rights. Furthermore, while property rights are recognized at the political and politico-economic levels, weak legal and judiciary systems may fail to enforce private property rights. This obstructs the active participation of the private sector in the economic development of these countries. Additionally, respect for property rights is an indication of the commitment of the State to the market economy, which translates into a commitment not to engage in such anti-liberalizing measures as the seizure of assets, expropriation and nationalization.

However, within the context of enforcing property rights, while political inertia remains the principal hindrance, there are other factors at play, namely, inadequate income distribution, political tensions and ethnic conflicts.[15] The issue of property rights is therefore dependent upon the prevailing economic policy, particularly its impact on economic growth, and on income distribution. This is the flip side of the equation since a lack of property rights protection can lead to poor economic growth, and that without the enforcement of property rights, "participation in some market activities is discouraged by the prospect that anyone engaging in such activity is unlikely to receive its full benefit".[16] This close relationship between property rights and economic growth requires that the implementation of economic policy reform go hand in hand with institutional reform.[17]

Protection of property rights implies protection against expropriation, nationalization, theft, repudiation of contracts and corruption. It involves the respect for contracts by the State with regard to property rights, including such cases where the State needs to expropriate private property for public projects. Moreover, this respect for contracts against theft, damage and other violations must gain the support of the general public. There is a widespread distrust among the private sector of States that are committed to the protection of property rights, particularly in the former Soviet Union, Africa and Latin America.[18] This resulted in lower participation by the private sector in those countries, which negatively affected economic growth.

Stable macroeconomic policy promotes property rights, while unstable policy is detrimental to its protection. According to Keynesian theory, inflation is a major factor in weakening property rights since long-term inflation confiscates an important part of private wealth.[19] Moreover, inflation discourages the private sector from actively participating in the privatization process and, therefore, from playing a major role in economic reform. Success in economic reform, particularly the privatization of SOEs, requires the protection of property rights, which is the principal objective of institutional reform.

The protection of property rights, particularly IPR, promotes research and development (R and D) by preventing theft and infringements on patented rights. However, a weak protection of IPR discourages R and D because "potential pirates can diminish the profitability of the firm's activity in that market".[20] Through local R and D initiatives, the protection of IPR is therefore key in attracting foreign investors. This is particularly relevant in those investments where technology transfer is involved given the increase in the

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[15] According to the World Bank, social polarization, which is defined as income inequality, land inequality and ethnic tensions, is undermining the concept of property rights since it can force the Government away from its property rights protection. S. Knack and P. Keefer, *Polarization, Politics and Property Rights: Links Between Inequality and Growth*, the World Bank, August 2000, p. 14.

[16] E. Dabla-Norris and S. Freeman, *The Enforcement of Property Rights and Underdevelopment*, International Monetary Fund (IMF), September 1999, p. 3.

[17] Ibid., p. 20.

[18] In a survey of private entrepreneurs conducted by the World Bank in 1997, approximately 80 per cent of those surveyed expressed a lack of confidence in the role of the State in protecting personal and property rights. A. Brunetti, G. Kisunko and B. Weder, *Institutional Obstacles for Doing Business: Data Description and Methodology of a Worldwide Private Sector Survey*, the World Bank, 1997, p. 18.

[19] L. Hoskins and A.I. Erias, "Property rights: the key to economic growth", *The Index of Economic Freedom*, The Heritage Foundation, 2002, p. 7.

[20] C. Fink and C.A. Primo Braga, *How Stronger Protection of Intellectual Property Rights Affects International Trade Flows*, the World Bank, February 1999.

share of technology-based products in international trade.[21] International corporations are discouraged to trade with those countries that do not respect IPR because of the risk of low profitability. Moreover, given the impact on economic efficiency, productivity and competitiveness of local products, developing countries have focused on technology transfer to increase their share of world trade and integrate into the global economy.

### 3. *Objectives of the protection of IPR*

The main objectives of the protection of IPR include the following: (a) to promote higher access to FDI; (b) to grant easy access to new technologies; (c) to assist in building a domestic R and D base; (d) to reduce infringements on patents and copyrights; (e) to promote domestic competition, thereby increasing exports; (f) to develop human resources in developing countries; (g) to contribute to economic diversification; (h) to facilitate the integration into the global economy; and (i) to narrow the digital divide.

### 4. *Increasing FDI by protecting IPR*

Respecting property rights provides a positive impact on the inflow of FDI.[22]. More specifically, the lack of protection of IPR discourages inflow of FDI towards such technology-based industries as the pharmaceutical industry.[23] Moreover, impact of FDI on economic growth is more feasible in those countries applying "export-promotion rather than import-substitution" macroeconomic policies.[24] Therefore, by encouraging domestic production, the protection of IPR contributes to the establishment of a domestic R and D base, which further promotes the inflow of FDI in technology-intensive industries. Additionally, respecting IPR encourages the local private sector to take risks and increases investments and R and D activities, which contribute to a general increase in productivity and development of human resources.

The protection of IPR is therefore an important part of the overall economic strategy of the State to increase its share of global FDI. The impact of technology transfer embodied in the inflow of FDI can be positive only with the existence of adequate human capital.[25] Lack of human capital can limit the absorptive capacity of technology transfer. It is therefore vital to give priority to the human development as part of the efforts to benefit from the FDI-related technology transfer. This implies that the impact of technology transfer is not automatic but conditional on local economic conditions, which differ from one country to another.

However, there have been cases of a negative impact of FDI technology on economic growth. Several studies have concluded that the strength of the protection of IPR in some developing countries reduces the FDI-related technology transfer since it has increased the cost of imitation.[26]

### 5. *Obstacles to the protection of IPR*

International corporations consider the protection of IPR as a prerequisite to their activities in R and D in the host countries.[27] However, the protection of IPR is particularly sensitive for developing countries.

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[21] The share of technology-based products in international trade increased from 12 per cent in 1980 to 24 per cent in 1994. Ibid.

[22] A survey of 24 economies in transition in 1995, which was conducted by the European Bank for Reconstruction and Development (EBRD), concluded that lack of protection of IPRs has had a negative impact on FDI. B.K. Smarzynska, *Composition of Foreign Direct Investment and Protection of Intellectual Property Rights: Evidence from Transition Economies*, the World Bank, February 2002.

[23] Ibid.

[24] K. Saggi, *Trade, Foreign Direct Investment, and International Technology Transfer: A Survey*, the World Bank, 2000, p. 29.

[25] Ibid.

[26] Ibid., p. 36.

[27] In the United States, 80 per cent of the manufacturing firms consider this issue vital in the area of R and D. B.K. Smarzynska, *Composition of Foreign Direct Investment and Protection of Intellectual Property Rights: Evidence from Transition Economies*, the World Bank, February 2002, p. 4.

Given that most of the global R and D in the field of science and technology (S and T) is undertaken in developed countries, these States have been the strongest proponents with regard to the protection of IPR. This arises from a near monopoly by developed countries in terms of control of patents.[28] Developing countries are at a distinct disadvantage given their modest spending on R and D. More damagingly, the protection of IPR can translate into limiting the inflow of technology from developed to developing regions.[29] Moreover, "the destination country loses from tighter protection whereas the source country is usually better off".[30]

(a) *Ownership of land*

One of the most vital aspects of property rights is land ownership and registration. This is particularly relevant in developing countries where most of the population lives in rural areas, and where agriculture is the main economic activity. In this respect, "security of tenure can raise the expected return from investment and ease credit constraints", which raises investment and productivity.[31] On the other hand, the "absence of secure property and contractual rights discourages investment and specialization".[32] Productivity can increase where land ownership is complete.[33] Moreover, land registration can have a positive effect on financial development, with public spending on land registration having a positive impact on economic growth.[34] Land registration encourages investment as it can be used as collateral for bank loans, thereby contributing to increases in agricultural production, and hence economic growth. Additionally, land ownership leads to an increase in retail prices, which benefits landowners and provides a source of income for those unable to invest in the agricultural sector.

However, the issue of ownership remains sensitive for developing countries, particularly in terms of foreign ownership of land, real estate and mining properties. Several countries have allowed foreign ownership of real estate but not of land, or have limited the surface area of land that foreign investors can own, while others have offered project land and property under long-term leases. In several countries in the ESCWA region, the strategic oil and gas sector, which was nationalized in the early 1970s, is now being considered as an opportunity for foreign investment. However, these countries must balance the local resistance to foreign ownership with the need to attract FDI and promote a domestic technological base, thereby enhancing economic efficiency, productivity and competitiveness.

(b) *Patented rights*

The application of IPR, particularly in the area of patented rights, can have a negative impact on prices in developing countries. A study conducted on the impact of patent protection in the pharmaceutical industry in India, concluded that new drugs that were simply a new type of an existing medicine had a modest impact

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[28] According to the Center for International Private Enterprises (CIPE), developed countries control 99 per cent of existing patents in the world. G.B. Price, "Protecting intellectual property: how new democracies stand to gain", *Economic Reform Today*, CIPE, 1995, No. 3.

[29] These issues were debated at the Fourth Ministerial Conference, which was organized by the World Trade Organization (WTO), in Doha, 22-23 September 2001.

[30] C. Fink and C.A. Primo Braga, *How Stronger Protection of Intellectual Property Rights Affects International Trade Flows*, the World Bank, February 1999.

[31] *World Development Report 2002*, the World Bank, 2002, p. 3.

[32] S. Knack and P. Keefer, *Institutions and Economic Performance: Cross Country Tests Using Alternative Institutional Measures*, IRIS Center, reprint No. 65, November 1995, p. 207.

[33] In Peru, land productivity increased by approximately 40 per cent in areas where land ownership had been completed compared with areas of non-registered land. "Securing property rights: the foundation of markets – an interview with Hernando de Soto", *Economic Reform Today*, CIPE, 1996, No. 1, p. 5. Available at: http://www.cipe.org/publications/fs/ert/e19/desoto.htm.

[34] F.F.K. Byamugisha, *How Land Registration Affects Financial Development and Economic Growth in Thailand*, the World Bank, Working Paper No. 2241, November 1999.

on prices, whereas new drugs that were medical breakthroughs had prices that were "significantly above competitive levels" and could create substantial losses to the welfare state.[35]

(c) *World Trade Organization (WTO)*

According to WTO rules and regulations, developing countries must amend their respective patent institutions to be compliant with Trade-Related Intellectual Property Rights (TRIPs) before 2005. However, this is a relatively short grace period given that these countries need to upgrade their technology-oriented industries in order to compete internationally. This is a key consideration since domestic market shares could otherwise be lost to foreign industries that are more technologically advanced, particularly from developed countries. The onus is therefore on those developing countries that managed to allocate large investments on building local, technology-intensive industries over the years, and that now face the threat of exposure to international competition. Developing countries need to work at the WTO level with the aim of extending the grace period beyond 2005, thereby allowing more time to adjust and improve their technology-based industries, particularly in the pharmaceutical, software and other electronic sectors. Failure in this regard could endanger these industries, which could have severe consequences in terms of losses in investment, market share and employment.

### 6. *International cooperation in protecting IPR*

Owing to the importance of IPR at the global level, several international conventions have been formulated, including the Paris Convention for Patents and Trade Markets, and the Berne Convention for Copyright.[36] Moreover, the Uruguay Round of Multilateral Trade Negotiation discussed the issue of IPR and drafted an agreement on the subject under TRIPs.

## B. ENFORCING CONTRACTS

### 1. *Defining contracts*

A contract is defined as "an agreement among individuals with specific identities on property rights to goods".[37] Contracts are an integral part of the market economy. They specify the nature, duration, conditions and the amount of the transaction. They are legally binding documents to ensure that all parties to any given deal deliver on their obligations and carry out its conditions. The need for contracts has become more important because of the diversity of the parties to a contract or a deal, which can typically include the seller, buyer, insurer and financier. Moreover, the physical distance between the different parties to a deal necessitates binding contracts. Since transactions in capital markets are largely not self-enforcing, there is a need for contracts and for an enforcement mechanism by a third party.[38]

In order to be effective, a contract must contain all the relevant information with regard to the transaction, including the date, value, names of beneficiaries and penalties incurred for infringements as stipulated in the agreement. In addition to being detailed, a contract needs to be drafted in a wording that facilitates interpretation and encourages a better understanding of the obligations. This is particularly important in developing countries where there are comparatively high illiteracy rates and where the concept of a market economy remains relatively new.

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[35] C. Fink, *How Stronger Patent Protection in India Might Affect the Behavior of Transnational Pharmaceutical Industries*, the World Bank, Working Paper No. 2352, May 2000, p. 29.

[36] The World Intellectual Property Organization (WIPO) manages both these Conventions.

[37] A. Grief and E. Kandel, *Contract Enforcement Institutions: Historical Perspective and Current Status in Russia*, IRIS Center, Working Paper No. 92, November 1993, p. 2.

[38] C. Clague and others, *Contract-Intensive Money: Contract Enforcement, Property Rights and Economic Performance*, IRIS Center, 1997, p. 4.

Moreover, there is still a widespread tradition in many developing countries to conduct trade on the basis of personal trust using social conducts and norms, rather than resorting to legally binding contracts. While this traditional method can work well in a relatively small and closed economy, it fails in a liberalized economy where trade is open and global, and where there is little prior knowledge and personal contact between the parties.

### 2. *The role of the State in enforcing contracts*

To some economists, the issue of enforcing contracts plays such a major role within the economy that they describe it as an alternative definition of economics.[39] Contract enforcement is the responsibility of the third party, which is primarily the State through its legal and judiciary institutions. The reform of these institutions is therefore necessary to provide support with regard to enforcing contracts. An efficient legal institution reduces the cost of enforcing contracts. In the absence of these institutions, settlement can only be achieved out of court, which usually involves additional payments. Furthermore, efficient legal and judiciary institutions provide incentives for the parties to the contract to make long-term commitments, which encourages the inflow of FDI.

Although the legal and judiciary institutions are the most typical enforcers of contracts, other third parties can be called upon to fulfil such a role, particularly in those countries where the legal system is either inefficient or procrastinatory. An unbiased panel of experts can be instructed to study the conditions set in a contract, arbitrate and pass judgment to settle any infringement. This type of enforcement mechanism is used in both developing and developed countries.

Enforcing contracts must play a dual role, namely, to promote the benefits of adhering to contracts and to discourage non-adherence.[40] Within the context of the latter, an efficient enforcing mechanism must aim to punish those parties that renege on their contractual commitments. This punishment can take various forms, including financial penalties as stipulated in the contract or in the law of the State; the revocation of a business licence; and incarceration.

By enforcing contracts, the State indicates both its commitment to the market economy and its determination to protect property rights. The State must therefore set a positive example by respecting its own contractual obligations, particularly with the private sector. Failure to honour such contracts or delaying payments to the private sector can severely damage the economic credibility of the State, discourage the active participation of the private sector and generally cause distrust in the business environment with regard to the implementation of institutional reform.

Contracts can be enforced in the following ways: (a) automatically, as stipulated in the contract without recourse to legal procedures or arbitration; (b) by coercive measures through agencies of the State; and (c) by agreed-upon arbitration through a panel of experts.[41] The first option is the most favourable since it does not involve additional transaction cost, while the other two require additional cost either to the arbitrator or to the courts of the State. Moreover, the first option best describes a smooth market economy. It therefore underlines the commitment by all parties to meet their respective obligations as stipulated in a legally binding contract.

## C. CORPORATE GOVERNANCE

### 1. *Defining corporate governance*

Corporate governance can be defined as "the institutional environment in which citizens interact among themselves and with Government agencies officials".[42] Moreover, it "deals with the ways in which

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[39] One of these is the Nobel Laureate, J.M. Buchanan who describes economics as "the science of exchanges". O. Williamson, *The Lens of Contract: Applications to Economic Development and Reform*, IRIS Center, February 2002, p. 3.

[40] Ibid., p. 10.

[41] A. Grief and E. Kandel, *Contract Enforcement Institutions: Historical Perspective and Current Status in Russia*, IRIS Center, Working Paper No. 92, November 1993, p. 35.

[42] *Governance: Sound Development Management*, ADB, August 1995, p. 3. Available at: www.adb.org/Documents/Policies/Governance.

suppliers of finance to corporations assure themselves of getting return on their investment".[43] Corporate governance is part of the general governance of the economy, and aims to create an enabling environment in which economic agents interact and economic activities are carried out. The success of institutional reform is therefore contingent upon the quality of governance.[44]

Corporate governance improves efficiency and promotes higher productivity, which is the main factor for higher economic growth, particularly export-led economic growth. Moreover, the "quality of governance and institutions is important for explaining rates of investment".[45] Good corporate governance induces higher investment, which is vital for corporate finance and expansion. In this respect, many economists believe that good governance is vital to sustain growth and hence living standards. Additionally, they attribute the difference between the level of economic growth and development not to the different level of resources or aid, but to the absence of good governance.[46] This partly explains the different levels of economic growth achieved by developing countries during the past three decades.

### 2. *The roles of the private sector and the State*

The new concept of economic growth does not limit itself to the availability of natural resources but to the type of governance both at the State and corporate levels.[47] Lack of good governances discourages the introduction of new technologies and production techniques, and private investments tend to concentrate on distributive functions rather than on the production of goods and services. This is owing to the fact that lack of good governance both at the State and corporate levels discourages long-term investment, thereby contributing negatively to economic growth and development. Furthermore, it reduces investment in STI and human resources, which directly reduces the competitiveness of domestic products, thereby discouraging exports. For this purpose, while making their investment decisions, donor countries focus on key governance indicators, including the share of public sector in the economy and the share of Government expenditure.[48]

The growing role of the private sector in economic activities has prompted the need for special State institutions aimed at organizing the relationship between the corporations in the public sector and the State, and between these corporations and investors. Within the context of the latter, this need arises from a division between the owners, generally the shareholders, and the executive manager, namely corporate managers and chief executive officers. Moreover, given that SOEs operate differently from private corporations, the shift of ownership of enterprises from the State to the private sector has generated a need to adapt corporate laws to these structural and organizational changes.

Similarly, in the post reform era, the role of the State has shifted from that of owner of SOEs to that of manager of the economy. In that regard, good governance of the economy requires the State to commit to the following: (a) to implement stable macroeconomic policies; (b) to provide Government services and prevent market failure; and (c) to promote accountability, participation, predictability and most of all transparency.[49]

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[43] J.D. Sullivan, *Corporate Governance: Transparency between Government and Business*, CIPE, 2000, p. 4. This paper was submitted to the Mediterranean Development Forum 3 (Cairo, 7 March 2000).

[44] Ibid., p. 4.

[45] M. Olsen, N. Sarna and A.V. Swamy. *Governance and Growth: A Simple Hypothesis Explaining Cross-Country Differences in Productivity Growth*, IRIS Center, Working Paper No. 218, July 1998, p. 6.

[46] S. Knack, *Growth and Governance: Measurement and Evidence*, the World Bank, February 2002.

[47] This new thinking is largely attributed to D. North. According to North, "opportunities for political and economic entrepreneurs overwhelmingly favour activities that promote redistributive rather than productive activities, that create monopolies rather than competitive conditions". D. North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, 1990, p. 9.

[48] S. Knack, *Growth and Governance: Measurement and Evidence*, the World Bank, February 2002, p. 2.

[49] *Governance: Sound Development Management*, ADB, August 1995, p. 7.

The lack of accountability of State officials undermines the capacity of Government to sustain the "long-term business confidence essential for growth-enhancing private sector investment".[50] Moreover, the lack of public participation in the economic decision-making process increases public resistance to policy changes, particularly in the case of privatization where this participation is essential. Enhancing transparency is therefore a key priority since the private sector participates in the economic growth and development of a country when it is provided with adequate and relevant information. The lack of such information increases economic speculation, undermines public trust in the economic policies of the State and hinders the implementation of policy changes.[51]

### 3. *The objectives of corporate governance*

The following points serve to outline the principal objectives of corporate governance:

(a) To promote economic efficiency through transparency and close monitoring of corporate activities aimed at fighting corruption and antitrust practices, reducing waste of financial resources and discouraging other restrictive business practices;

(b) To protect investors from the misuse of financial resources by corporate managers through frequent financial disclosures, thereby ensuring the viability of their financial positions and enhancing supervision;

(c) To further enhance supervision and monitoring by shareholders by enabling them to vote for executive managers and on such key issues as mergers and acquisitions;

(d) To promote competition and combat monopolies in the marketplace to ensure fair operation of the market economy;

(e) To encourage the respect for the institutions of the State, including labour, trade and financial institutions;

(f) To protect the interests of shareholders, particularly those with minority shares.

Good corporate governance can be achieved in the following ways: (a) by privatizing SOEs, which promotes efficiency and competition in the market; (b) by developing capital markets, which represent the main source of corporate finance; (c) by closely monitoring the operations of the banking system; and (d) by improving the accounting and auditing system in order to handle the financial performance of private corporations more effectively.

### 4. *Increasing FDI through good corporate governance*

The wave of privatization that has swept economies in transition and developing countries since the early 1980s has created a strong need to formulate and enforce institutional reform related to corporate governance. This need has grown in urgency given the spread of corporate mergers and acquisitions in both developed and developing countries.

The collapse of several major corporations in developed countries has been attributed to poor corporate governance, including the high-profile cases in the United States of America in 2002 of the Enron

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[50] Ibid., p. 9.

[51] In a survey conducted by the World Bank in 1997, more than 80 per cent of private sector enterprises in CIS and Africa indicated that their concern over Government policies are not considered by the State. A. Brunetti, G. Kisunko and B. Weder, *Institutional Obstacles for Doing Business: Data Description and Methodology of a Worldwide Private Sector Survey*, the World Bank, 1997, p. 13.

Corporation, Xerox and WorldCom. Failure in corporate governance has equally been used to explain the ongoing financial crisis in East Asia.[52]

Moreover, the substantial increase in the inflow of FDI has added to the importance of corporate governance, particularly with regard to mergers and acquisitions. Given that good corporate governance is a key factor for foreign investors, developing countries have adopted new laws to govern the establishment and operation of corporations and with a view to increasing their share of FDI through mergers between domestic firms and transnational corporations.

Furthermore, the change of the type of ownerships has played an important role in formulating corporate laws. In developing countries, there is a comparatively larger proportion of closed, mainly family-run businesses with respect to shareholding companies. The globalization of the world economy has forced developing countries to change and strengthen their corporate laws to be compatible with international norms in order to facilitate the inflow of investment and encourage transnational mergers and acquisitions. Additionally, the liberalization of trade and the need to promote exports into new markets in the globalized economy require higher productivity and greater competitiveness and efficiency. This translates into an urgent need for better corporate governance to attract foreign expertise and management techniques.

### 5. *Obstacles to corporate governance*

The success of corporate governance hinges on the smooth interaction between the laws of the State, corporate management and stockholders or investors. This tripartite relationship is a function of the mechanism that enforces corporate governance, which itself is linked to the following: (a) the efficiency of the State in dealing with corporate governance; (b) the level of independence from political interference; (c) the legal and judiciary system, particularly in its response to violations of State institutions by private corporations; (d) the willingness of stockholding associations to contribute to the implementation of corporate governance by closely monitoring financial operations; and (e) the effectiveness of the auditing system and auditing agencies to effectively monitor corporate activities. Within that context, the media can play a major role in uncovering and disseminating both corporate violations of State institutions and mismanagement by private corporations.

#### (a) *Violations by private corporations*

The issue of corporate governance is new in developing countries. Moreover, given that State institutions are still being developed, these countries lack the needed experience to deal effectively with multilateral corporations in developed countries. Additionally, legal and judiciary institutions are being reformed and often lack the capability to respond adequately and swiftly to violations by private corporations.

In the majority of developing countries, including ESCWA members, the comparatively larger proportion of closed, mainly family-run businesses with respect to shareholding companies has "left insiders with excessive power to pursue their own interests at the expense of minority shareholders". [53] Moreover, the stock markets in most developing countries are relatively small and underdeveloped with limited monitoring tools for the operations of private corporations.

The relatively weak institutional framework in developing countries poses a further challenge to corporate governance. Within the context of the dissemination of information on the operations of private corporations, most of the relevant data are usually published relatively late and, in many cases, after violations of corporate governance have occurred. This constrains the ability of the State to prevent such

[52] A report by ADB in 2000 concluded that those countries in East Asia that had been the most affected by the crisis lacked good corporate governance. M.V. Capulong and others, *Corporate Governance and Finance in East Asia*, ADB, 2000, vol. 1, p. 1.

[53] This issue was described as one of the key factors that caused the financial crisis in East Asia in 1997-1998. Ibid., p. 2.

violations. Moreover, there is a strong resistance to change in developing countries by those with a vested interest in maintaining the status quo, particularly corporate managers and politicians.[54]

(b) *Lack of corporate culture*

While the separation of ownership and corporate management has contributed to the creation of highly skilled managers in developed countries, particularly the United States, in many economies in transition and developing countries, corporate managers are selected according to their close relationships to influential politicians.[55] This can be attributed to a lack of corporate culture in countries where, until very recent, SOEs were the major players in economic activities. This is further evidenced by the fact that, despite privatization, several State officials have been chosen to manage the newly privatized companies, thereby implying an unbroken affiliation to the State. This practice, which runs contrary to a true meritocracy, diminishes the successful implementation of corporate institutions.

(c) *Reform of the financial system*

Corporate governance is complex and can only be effective if it is implemented as part of a package of institutional reform. Within that context, the reform of corporate governance cannot be considered complete without similar reform of the financial system, particularly the banking sector and the stock market. Corporate finance is closely related to the issue of corporate risk, which, in turn, is strongly linked to the protection of property rights and the availability of a market economy.[56] Moreover, the strength of shareholder rights and the type of financial system are important factors in determining the level of corporate risk. Essentially, increasing the protection of investor rights reduces risk.[57] In developing countries, including ESCWA members, the financial and legal frameworks are being reformed to take into account the transformation into market economies. This can therefore increase corporate risk and have a negative impact on the soundness of corporate governance in the short- to medium-term future.

(d) *Reform of the judiciary system*

Corporate governance cannot be successfully implemented where there is a weak judiciary system that fails to protect the rights of shareholders, particularly those with minority shares. Judiciary systems that are weak, slow or inexperienced undermine the whole concept of good corporate governance. This hinders efforts by corporations to access new investments, including those depending on stock markets for finance. Moreover, corporate governance plays a greater role in those countries where both the rights of investors and the judiciary system are weak.[58] Therefore, at the early stage of reform, where the judiciary and legal system is still inefficient, corporations can still manage to improve the trust of their investors by focusing on the protection of their rights. However, while corporations can enhance these rights, this is not a substitute for an efficient legal system.[59]

### 6. *International cooperation in corporate governance*

Corporate governance has become a global concern with the integration of the world economy through the liberalization of trade and investment, and as a result of the sharp rise in the number of mergers and

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[54] C.P. Oman, *Corporate Governance and National Development*, Organization for Economic Cooperation and Development (OECD), September 2001, p. 20.

[55] Ibid., p. 24.

[56] These were the conclusions of a study by the World Bank in 1995-1996, which covered 11,000 firms in 46 countries. S. Claessens, S. Djankov and T. Nenova, *Corporate Risk around the World*, the World Bank, January 2000, pp. 2-3.

[57] Ibid.

[58] These were the conclusions of a study by the World Bank that covered 495 companies in 25 countries. L.F. Klapper and I. Love, *Corporate Governance, Investor Protection and Performance in Emerging Markets*, the World Bank, April 2002, p. 21.

[59] Ibid., p. 22.

acquisitions in both developed and developing countries. This new reality requires the formulation and reform of institutions in order to improve corporate activities. Within this context, the Organization for Economic Cooperation for Development (OECD) has highlighted the ideal structure of corporations, management and activities of corporations, and has formulated the key principles for good corporate governance, including the rights of shareholders, the role of employees, transparency and accounting.[60]

## D. COMPETITION LAWS AND REGULATIONS

### 1. *Defining competition*

Competition is the basis for a market economy. It promotes the role of the private sector and encourages the inflow of FDI. Moreover, competition has a direct and positive impact on economic growth since it "increases efficiency by providing incentives to managers to reduce costs, innovation and improve the institutional arrangements to production".[61]

Additionally, competition "has pervasive and long-lasting effects on economic performance by affecting economic actors' incentive structure, by encouraging their innovative activities, and by selecting more efficient ones from less efficient ones".[62] Competition adds vitality to the marketplace in a number of ways, including (a) by forcing corporations to cut costs through the application of new technologies and production techniques, thereby contributing to the competitiveness of local products in international markets; (b) by increasing managerial expertise, thereby lessening corporate losses and bankruptcies;[63] (c) by developing human resources through an increase in demand for skilled employees, which promotes education, particularly technical, and which consequently improves economic and social development; and (d) by encouraging innovation and the application of new technologies through the establishment of a domestic R and D base.

### 2. *The role of the State*

Before economic reform, the State used to be directly responsible for the production of goods and services and, therefore, for quality and prices. In the post reform era, the role of the State has shifted from that of owner of SOEs to that of manager of the economy, which includes supervising the activities of the private sector to promote both economic efficiency and consumer satisfaction. This requires an active participation by the State to ensure that production is of high standards and within a competitive environment.

Additionally, the State needs to encourage the participation of private corporations in economic activities by facilitating entry into and exit out of the marketplace. Given the dynamic attitude towards the market and a high flexibility towards changes of production and knowledge of consumer tastes and needs, a competitive private sector can improve quality, reduce cost and promote the export potential of domestic products.

While competition in developed countries has evolved gradually over time, which enhances the success of institutional reform, most developing countries have had to adapt to international standards in a significantly shorter period. The issue of competition is therefore more complex and problematic in developing countries. The comparatively abrupt institutional reform calls for a selective process in tackling the issue of competition, namely, to link such reform to negotiations with WTO; to discern and strengthen those sectors that are more exposed to international competition; and to link the issue of competition to national development strategies, thereby prioritizing key sectors.

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[60] *OECD Principles of Corporate Governance*, OECD, 1999.

[61] *World Development Report 2002*, the World Bank, 2002, electronic edition, chapter 7, p. 133.

[62] S. Ahn, *Competition, Innovation and Productivity Growth: A Review of Theory and Evidence*, OECD, Working Paper No. 317, January 2002, p. 5.

[63] Ibid., p. 6.

### 3. *The objectives of competition laws*

One of the main objectives of the economic transformation process is to secure a competitive environment in the marketplace. The aim is to combat monopolies and antitrust conditions, which hinder competition and which reduce economic efficiency and productivity. Moreover, within the context of liberalizing laws and regulations, this aim constitutes a vital component of the drive towards a market economy, which is based on competition and liberalization. The main tools for promoting competition among economic agents in the market are antitrust laws and regulations, and laws that fight monopolies and unwanted mergers and acquisitions, particularly those that influence supply or prices of goods and services. Competition positively impacts the market in a number of ways, namely, by maintaining low costs and prices of goods and services; by enhancing quality; by promoting corporate R and D; and by encouraging suitable mergers with transnational corporations. These four aspects promote exports, particularly in a highly competitive globalized economy. On the other hand, lack of competition can lead to misallocation of scarce resources, price-fixing and control over the quality of supply. These lead to low-grade products that struggle to compete in international markets.

Legislation on competition must aim at the following: (a) to prevent monopolies, market control and unfair business practices by corporations; (b) to organize advertising campaigns to counter unfair or inaccurate commercials by corporations; (c) to organize and monitor mergers and acquisitions, thereby discouraging those that can jeopardize the competitive environment; (d) to ban the creation of cartels that tend to control supply and raise prices; (e) to remove barriers to entry and exit for corporations; (f) to promote economic efficiency, productivity and competitiveness of local products; (g) to promote the efficient allocation of resources and eliminate shortfalls in productions; and (h) to protect consumers from low quality products.

### 4. *Competition laws in the ESCWA region*

ESCWA members are lagging behind the rest of the developing world in the area of competition laws. In general, the economic reform policies in the ESCWA region started comparatively later than in other regions. The issue of competition is still being debated even in those member States that have engaged in economic reform, including Egypt and Jordan. While both these countries have adopted draft competition laws, these bills are still in the process of being promulgated. For competition laws to succeed, ESCWA members need to accelerate their economic reform process, particularly the implementation of privatization programmes aimed at reducing the involvement of the State in economic activities, liberalizing trade and regulating investment. Several member States are still stabilizing their macroeconomic policies, which constitute the first phase of economic reform.

Egypt, which is among the first group of countries in the ESCWA region to initiate economic reform, has drafted a competition law that covers a wide range of issues related to competition, including antitrust, restrictive business practices, merger and acquisition and anti-competition practices.[64] Once approved, the draft law will only apply to registered companies; those companies in the informal sectors will be exempt. In Jordan, the first draft of a competition law was formulated in 1996.[65] While a revised draft has since been submitted to the Financial Committee in the Parliament in Jordan, the bill has not yet been promulgated.

The issue of competition needs to be given a higher priority in ESCWA member States. Failure in this regard negatively impacts economic efficiency and discourages productivity and competitiveness of local products. Competition is the basis for the transformation into a market economy and hence the integration of national economies into the global economy. Furthermore, it plays a vital role in attracting FDI.

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[64] H. Nasser, *Competition Policy and Law in Egypt* (E/ESCWA/ED/2002/WG.1/4), p. 24. This study was presented to the Expert Group Meeting on Competition Laws and Policies: Identification of Common Ground in ESCWA Member Countries, which was organized by ESCWA (Abu Dhabi, 28-30 January 2002).

[65] Y. Mansur and B. Zu'bi, *Competition Law and Policy in Jordan* (E/ESCWA/ED/2002/WG.1/3), p. 8. This study was presented to the Expert Group Meeting on Competition Laws and Policies: Identification of Common Ground in ESCWA Member Countries, which was organized by ESCWA (Abu Dhabi, 28-30 January 2002).

### 5. *Increasing FDI through competition*

The creation of a domestic competitive environment increases the inflow of FDI, including mergers and acquisitions. In turn, the inflow of FDI promotes domestic investment and enhances the efficiency and quality of local products. This adds satisfaction among domestic consumers and generates new market opportunities by making local products more competitive in international markets.[66] Additionally, by applying higher standards in production and in management, the inflow of FDI enhances the production process.

Moreover, competition has become a global issue. In addition to enhancing intra-national competition among domestic firms and corporations, competition laws need to take into account competitive forces between domestic economies and the global economy. Local institutions must therefore promote competition that is compatible with international standards in order to meet the challenges of global competition and attract higher shares of FDI. Competition with developed countries is particularly challenging since these countries adopted a competitive environment long before developing countries.[67] The liberalization of trade and investment has put pressure on developing countries to adopt laws and regulations that are compatible with global ones. "International trade is particularly useful in promoting competitive markets in developing countries, where there are information difficulties, inadequate contract enforcement and human capital constraints."[68]

### 6. *Obstacles to competition laws*

While formulating competition laws and regulations is vital, it is equally vital to adopt a strong mechanism to enforce these laws. For this purpose, developing countries have established Government agencies to enforce the implementation of competition laws and regulations. However, in order to be effective, these agencies need to be independent from political interference and must be given full authority to carry out their mandate. One of the best examples of State agencies is the Federal Trade Commission in the United States, which was established in 1914 to fight antitrust and promote competition.[69] Similarly, many economies in transition have adopted specialized agencies to deal with competition.[70] In the ESCWA region, the draft competition law in Egypt includes the establishment of an agency responsible for implementing the draft law and under the direct supervision of the Prime Minister.[71]

In order to be effective, these State agencies need the following: (a) a clear mandate; (b) skilled and well trained human resources; (c) independence from political influence and interference in their operations; and (d) political weight, including the possibility of reporting directly to the legislative rather than the executive authorities.

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[66] L. Tineo, *Foreign Direct Investment in a Globalizing Economy: The Role of Competition Policy* (E/ESCWA/ED/2002/WG.1/7), p. 2. This study was presented to the Expert Group Meeting on Competition Laws and Policies: Identification of Common Ground in ESCWA Member Countries, which was organized by ESCWA (Abu Dhabi, 28-30 January 2002).

[67] In the United States, for instance, the competition law was adopted in 1890. *World Development Report 2002*, the World Bank, 2002, chapter 7, p. 139.

[68] Ibid., p. 143.

[69] W.E. Kovacic, *Economics, Politics, and Competition Policy in Transition: Perspectives from Experience in the United States* (E/ESCWA/ED/2002/WG.1/8), p. 11. This study was presented to the Expert Group Meeting on Competition Laws and Policies: Identification of Common Ground in ESCWA Member Countries, which was organized by ESCWA (Abu Dhabi, 28-30 January 2002).

[70] For instance, Bulgaria has established the Commission for Protection of the Competition (CPC). B. Hoekman and S. Djankov, *Competition Law in Bulgaria after Central Planning*, the World Bank, June 1997, p. 1.

[71] H. Nasser, *Competition Policy and Law in Egypt* (E/ESCWA/ED/2002/WG.1/4), p. 30.

(a) *Implementing competition laws*

In developing countries, the main obstacle with regard to competition laws is their implementation rather than their adoption. Lack of implementation can be attributed to several factors, including an insufficient number of skilled human resources; lack of financial resources; bureaucracy; and often a lack of political will. The competition culture, which takes times to be fully disseminated in a society, is still relatively new in many developing countries. Additionally, the problem can be exacerbated by a judiciary system that is ineffective in dealing with abuses of competition laws.[72]

(b) *Political interference*

In general, for a State agency to be effective in carrying out its responsibilities without political interference, it needs to be linked directly with the legislative authority. Its composition must come from Parliament.[73] In developed countries, the most effective agencies tend to be independent from the State.[74]

### 7. *International cooperation*

There are now over 80 countries worldwide that have implemented competition laws.[75] International efforts have intensified to assist those developing countries that have not yet formulated competition institutions. The United Nations Conference on Trade and Development (UNCTAD), OECD and the World Bank have been active in promoting global competitiveness. Additionally, WTO has established a working group on trade and competition. Given the increasingly competitive nature of the global economy, there is added pressure on those countries that have not implemented institutional reform. Without these reforms that promote competition, domestic economies cannot integrate into the global economy, which has negative consequences for domestic exports.

## E. CORRUPTION

### 1. *Defining corruption*

Corruption is defined as "the abuse of public office for private gains".[76] High levels of corruption negatively affect economic growth.[77] Moreover, corruption discourages investment and further dampens economic growth by increasing transaction costs for private sector investment, which reduces the incentive for investment, particularly FDI. Fighting corruption represents one of the most important elements of institutional reform in many economies in transition and developing countries. Corruption spreads in an environment that is characterized by a lack of both transparency and of institutional enforcement

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72 In Bulgaria, for instance, one of the main concerns was the refusal of courts to accept the penalties recommended by the competition protection agency. B. Hoekman and S. Djankov, *Competition Law in Bulgaria after Central Planning*, the World Bank, June 1997, p. 2.

73 *World Development Report 2002*, the World Bank, 2002, p. 142.

74 In a survey of 50 developed and developing countries conducted by the World Bank in 2002, in 63 per cent of developed countries, competition agencies are independent from the Government, while in developing countries the ratio is 51 per cent. This relatively high ratio is a reflection of the need to make these agencies more effective in their operations. However, the same survey concluded that in the area of staffing of competition agencies, developed countries have been more successful compared with developing countries. Ibid.

75 T. Winslow, *OECD Programs for Global Competition Issues* (E/ESCWA/ED/2002/WG.1/6), p. 5. This study was presented to the Expert Group Meeting on Competition Laws and Policies: Identification of Common Ground in ESCWA Member Countries, which was organized by ESCWA (Abu Dhabi, 28-30 January 2002).

76 S. Wei, *Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle?*, Harvard University and National Bureau of Economic Research, Working Paper No. 2048, February 1999, p. 2.

77 A study conducted by IMF in 1999 calculated that an improvement in the level of corruption by one standard deviation can lead to a 1.4 per cent increase in economic growth in the long term. C. Leite and J. Weidmann, *Does Mother Nature Corrupt? Natural Resources, Corruption, and Economic Growth*, IMF, Working Paper No. 85, July 1999, p. 25.

mechanisms. Economic liberalization reduces the incentive for corruption, particularly when it is coupled to a firm commitment by the State. Liberalization, including price liberalization, is therefore an essential part of the effort to combat corruption.

Moreover, owing to the increased reliance on small and medium-sized enterprises (SMEs) as the main sources for economic growth, and on the fact that corruption has a greater impact on these enterprises compared with large enterprises, the overall effect of corruption on growth can be even more negative.[78] In developing countries, the role of SMEs has increased in recent years as a major source for employment, production and thus economic growth. High levels of corruption are therefore even more damaging for developing countries compared with developed countries where large, multinational corporations play an important role in the economy. Furthermore, large corporations can deal more effectively with corruption given their influence and weight, whereas SMEs are less equipped to resist it given their comparatively limited resources and experiences.[79]

### 2. *The cause of corruption*

The diversion of financial resources can be for political goals, particularly for election purposes. In general, corruption in developing countries can be attributed to several factors, namely, a lack of institutional reform that promotes transparency; and a lack of competition in the marketplace. Moreover, the size of the public sector in the economy remains comparatively significant in a large number of developing countries. This constrains competition and economic efficiency, particularly in allocating resources. The political influence over SOEs remains a cause of concern in developing countries as a potential source of corruption, particularly in infrastructure and those Government services and sectors that can suffer from supply bottlenecks. Furthermore, salaries in the public sector are generally lower than in the private sector, which can tempt employees of the State into accepting bribes.

### 3. *The roles of the State and the private sector*

Corruption is generally highest in countries where price liberalization has not been implemented.[80] Moreover, the lack of competition, which can lead to misallocation of resources for political or social benefits, plays a major role in spreading corruption among politicians and in the marketplace. At the corporate level, the lack of good corporate governance can equally lead to the rise of corruption. During the pre-reform era, corruption was typified in SOEs, whereby, without genuine checks and balances conducted on the operations of these enterprises, politicians enjoyed special treatment, particularly in the areas of employment, marketing and production. This special treatment was largely based on reciprocity of benefits between the general managers of these enterprises and the State politicians, which paved the way for rising corruption levels.

Therefore, the formulation of an institutional framework that contributes to good governance, particularly corporate governance, represents an important step in the effort to fight corruption and enhance transparency. Furthermore, "it is central for transition economies to implement an effective competition policy regime in order to curb corruption".[81] The survival of the most competitive corporations leads to a strengthened and more liberalized marketplace, and to a less corrupt business environment. This can only be achieved by removing all barriers to entry and exit to and from the market.

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[78] This was the conclusion of another study by IMF, which covered 97 countries. V. Tanzi and H.R. Davoodi, *Corruption, Growth, and Public Finances*, IMF, Working Paper No. 182, November 2000, p. 7.

[79] A survey of approximately 3,000 enterprises in a large number of transition economies conducted by EBRD and the World Bank revealed that bribes represented 5 per cent of the annual revenues of small firms compared with less than 3 per cent for large firms. Ibid., p. 8.

[80] A study conducted by the World Bank in 2000, which covered several economies in transition, concluded that in both Russia and Belarus, the corruption was higher than in other countries where price liberalization was implemented. H.G. Broadman and F. Recanatini, *Seeds of Corruption: Do Market Institutions Matter?*, the World Bank, Working Paper No. 2368, June 2000, p. 3.

[81] Ibid., p. 5.

Additionally, bribes are typically lower in countries with a well-developed infrastructure.[82] This implies that infrastructure projects, which are usually large projects with substantial investments, can create an environment of corruption in the absence of mechanisms that enforce corporate governance. Moreover, "excess demand is an important determinant of corruption", particularly in the area of utility services where high demand and a limited expansion of services can induce employees to ask for additional payment for their repair services.[83] Within a market economy, competition can lead to an increase in supply, thereby removing bottlenecks that contribute to corruption. Similarly, privatization leads to an increase in supply and to the creation of a competitive environment, which have a direct impact in lessening corruption. Furthermore, given that effective checks and balances are observed more in private firms than in SOEs, privatization plays an additional, if indirect, role in the fight against corruption.[84]

### 4. *Increasing FDI by fighting corruption*

Corruption goes against the objectives of developing countries to attract higher rates of FDI. In general, FDI is dampened in a country that is characterized by high levels of corruption, regardless of inducements by the State, including tax incentives.[85] By negatively affecting the inflow of FDI, corruption leads to a lower inflow of new technologies that are associated with FDI, thereby hampering domestic productivity and reducing the export potential. The impact on productivity is particularly important since it negates national efforts aimed at enhancing competitiveness and promoting export-led economic growth. There is therefore an urgent need for political commitment at the highest level to fight corruption.

### 5. *Measuring the level of corruption*

There are several measures of corruption used by international institutions and business associations. They include the Business International Rules (BI), which are based on a survey of experts from a number of countries conducted during the early 1980s; the International Country Risk Guide (ICRG), which is an annual report produced by private investment risk services and based on the views of experts on these issues; the Global Competitiveness Report (GCR), which is based on a survey in 1996 designed by the Harvard Institute for International Development (HIID); and the Transparency International (TI), which is an NGO that produces an annual report on these issues.[86]

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[82] G.R.G. Clarke and L.C. Xu, *Ownership, Competition, and Corruption: Bribe Takers Versus Bribe Payers*, the World Bank, February 2002, p. 2.

[83] Ibid., pp. 2-3.

[84] The study concluded that "bribes paid to utilities are lower in countries with greater capacity and competition in the utility sector and where utility has been privatized". Ibid., p. 23.

[85] A study by the World Bank covering several Asian economies concluded that those Asian countries that had provided generous tax incentives to attract higher levels of FDI could have received the same or higher share had they controlled the corruption level. S. Wei, *Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle?*, Harvard University and National Bureau of Economic Research, Working Paper No. 2048, February 1999, p. 10.

[86] Ibid.

## III. CASE STUDY: EGYPT

### A. INTRODUCTION

This case study analyses the institutional reform in Egypt as an integral part of the overall economic transformation process. While significant results have been achieved in Egypt with respect to macroeconomic stability and credibility, a great deal of structural reform is still needed in order to fully achieve a sustainable economic growth. The challenges are to maintain the economic stability while pursuing further reforms of the economy. Of particular significance in this respect is the creation of an institutional set up that is amenable to development and growth. Without efficient institutions and effective enforcement mechanisms, the economy is unlikely to grow at a sustainable rate. An enabling and competitive institutional environment is widely acknowledged as an indispensable and complementary condition for high and sustainable growth. Bringing about the needed changes in the institutional set up, in addition to creating new ones, has been part and parcel of an extensive and wider reform programme for economic stabilization and structural reform.

In recognition of the role of institutions in economic growth, Government efforts are devoted to several reform actions with the following two aims: (a) to remove obstacles and constraints of an institutional nature that are hindering economic growth; and (b) to promote those institutions that are essential for the new market-based economy. This is based on a firm belief that unless institutional conditions are amenable to growth, heavy investment in human and physical capital and in developing productivity are likely to fail.

### B. INSTITUTIONAL REFORM IN EGYPT

The economic reform programme, which Egypt started to implement in 1990, comprises a number of components with diverse but economically consistent goals. It has targeted the restructure of economic activities along the lines of a free and competitive system with a view to attaining high and sustainable economic growth. Among these components, the institutional framework has enjoyed a high priority and is considered to be central to the success of the structural adjustment programme. The main objective is to improve the overall efficiency and productivity of the economy through institutional support with regard to market activities. Sound institutions promote high market specialization and competitiveness, and reduce uncertainty and transaction costs.

Within the context of its shift to a market-based economy, Egypt has undertaken economic reform programmes where the role of the State has been effective in some areas and less effective in others. During the past two decades, and within the framework of transformation and institutional building, Egypt has attempted to take into consideration the challenges posed by globalization and the integration into the world economy. However, while the reform programme brought the institutional dimension into focus, it failed to apply various technical measures of stabilization and structural adjustments, namely, (a) the legislative mechanism and the deregulation and decentralization processes were incomplete, which obstructed competition and raised transaction costs, thereby constraining economic growth; (b) the delayed or inadequate revision of property rights, particularly the body of laws pertaining to financial markets, incorporation and employment, discouraged the flow of private investment into the productive sectors of the economy; (c) inconsistencies between existing and new laws and regulations; (d) the lack of transparency in many of the new provisions; and (e) a failure to reform the administrative apparatus of the State and introduce strict but simple operating procedures, thereby encouraging good governance.

With the structural reform still in progress, deregulation has proceeded with the control of public sector monopolies and reforms of investment licensing. Within the context of the legislative mechanism, legal and regulatory changes have brought about prudential improvements in favour of the structural reform programme, which rationalize the regulatory function of the State. In the field of securities, market dealings have been legally instated to encourage commercial arbitration settling disputes. Furthermore, legal reforms have been introduced to bring about necessary key institutional changes that develop and enhance the business environment, thereby encouraging private investments and FDI. Priority has been given to those new or revised laws that enable institutional changes.[87]

These legislative and institutional reforms have enhanced the role of the State as a regulator and provider of an enabling environment for economic growth, thereby allowing it to focus on the social and welfare aspects of development and to transfer the economic role to the business community. An indicator to this revised role of the State is the trend in Government expenditure, including shifts in the national budget that reflect the relevant polices in the process of reform. This is typified by a decrease in investment and an increase in the areas of education, health, housing and welfare.

Moreover, a number of necessary laws have been enacted to support the role of the private sector. They concern the creation of an enabling environment for a market economy, thereby promoting domestic and foreign business development and impacting economic growth. The salient features of these laws are provided below.

### 1. *Privatization*

The privatization programme in Egypt started in 1991 with the enactment of the Public Business Sector Law.[88] The principal aims of this Law were to restructure SOEs, to increase commercial orientation and to improve accountability by management. It abolished the Government authorities that had previously supervised SOEs and replaced them with 17 State-owned holding companies, thereby avoiding the possible concentration of a company within any given sector. The holding companies defined, administered and implemented the privatization of 314 non-financial affiliate companies.[89] These affiliate companies own holdings in a further 184 joint venture companies, which provide a means of creating partnerships between the private and public sectors.

Additionally, this Law created the Ministry of Public Enterprise, which is responsible for the overall privatization programme, and established the Public Enterprise Office (PEO) as the advisory body of that Ministry.

The central component of the structural adjustment programme was the reform of SOEs. The goal was to improve the overall efficiency and productivity of the economy through a privatization programme, and to reform the policy environment within which the public sector operates. The latter includes reforms of the legal framework and of the organizational and institutional structure.

The main aim of the privatization programme was to promote the increase of the private sector ownership and management of SOEs through a variety of methods, including: (a) the divestment of public sector equity in joint venture enterprises set under investment laws; (b) the sale of over 2,000 small enterprises that belonged to local governments; (c) the sale of assets considered marginal to these activities; (d) the lease and/or sale of unused production facilities to the private sector; and (e) the removal of legal impediments to the sale of public sector shareholdings in SOEs, thereby paving the way for their gradual privatization.

Additionally, the Law enabled the Government to establish a structure in which the public enterprises have autonomy and operate on an equal footing with the private sector in terms of management, access to such factors of production as pricing and marketing, and accountability in terms of results and profits. With the ultimate objective of liberalizing SOEs from Government intervention, ownership rights were separated from the management of State-owned capital through a new, three-tiered organizational set up comprising an institution at the top, holding companies in the middle and their affiliated companies at the base. This new

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[87] These include the following: the Banking Law (No. 101 of 1993); the Foreign Exchange Law (No. 38 of 1994); the Investment Law (No. 8 of 1997); the Capital Market Law (No. 95 of 1992); the Public Business Enterprise Law (No. 203 of 1991); the Companies Law (No. 159 of 1981); the Tax Law (No. 157 of 1981); and the Environment Protection Law (No. 4 of 1994).

[88] No. 203 of 1991.

[89] These are commonly known as Law 203 companies.

institution, namely, PEO, which operates under the guidance of the Cabinet of Ministers and the Ministry of Public Enterprises, has the main function of advising holding companies and their affiliates with regard to such issues as the privatization programme, liquidation and the management of State assets. Moreover, it monitors the financial performance of the holding companies and ensures strict auditing. These holding companies, each with its number of affiliate companies, have the following principal objectives: (a) to pursue financial profitability; (b) to diversify their activities vertically and horizontally; (c) to buy and sell enterprises, either partially or wholly; and (d) to liquidate non-viable businesses.

The main instrument for effecting these institutional changes was the enactment of the Public Enterprise Law, which replaced Public Sector Law 97, in order to provide managerial autonomy and accountability, to enhance competition, to facilitate privatization and to subject the holding companies and their 314 affiliated companies to financial discipline. This discipline was further extended to cover other relevant issues in the areas of labour, employment and pricing policies. The liberalization of prices in the public sector has been essential for the creation of a market-based public sector system. Moreover, pursuant to this new legislation, all public sector organizations were transformed into holding companies exercising the same authority and operating under the same restrictions.

Given the profound implication of this new legal framework, particularly in the early stage of privatization, the process was hampered by a protracted debate on the matter. The issue was eventually referred to the constitutional court, which upheld the right of the Government to transfer public ownership to the private sector. While this first phase of privatization concentrated on the divestment of public sector equity, new and creative solutions need to be introduced in order to deal with problematic companies and other joint venture enterprises owned in part by the holding companies, particularly in the financial sector.

### 2. *Property rights and IPR*

Property rights in Egypt are governed by the provisos of the Civil Code,[90] which cover all aspects and forms of property rights, including the rights of owners; the scope and methods of protection of property; restrictions on property rights; and applicability of these rights with respect to individuals, joint owners and juridical entities.[91] Within the context of a global, knowledge-based economy, the focus has shifted from the material protection of property to the protection of IPR. There is therefore an urgent need to provide due protection, particularly given the increase in international trade.

The agreement on TRIPs has a special nature and scope. This agreement commits all member States in WTO to protect IPR through internal laws and legislation. This necessitates the issuance of legislation and regulation in alignment with the agreement, which differs from other trade agreements in the following ways:

(a) It is a comprehensive agreement dealing with all forms of property rights, including, *inter alia*, trademarks, geographic indicators and patents;

(b) It does not force member States to implement unified rules for IPR, but it obliges them to secure minimum levels of rights and protection;

(c) It is the first international agreement in the area of property rights that addresses the settlement of disputes that can arise between member States;

(d) It requires developed countries to align their legislation with the agreement starting 1 January 1996, and allows a grace period of four years through January 2000 for developing countries;[92]

[90] Article 196 of the Civil Code (No. 131 of 1948) deals with the issue of property rights.

[91] The general consensus among legal professionals is that, while the Civil Code provides full protection of property rights and that there is no supportive justification for a new law, the applications of the provisions, capacity and spirit of the Code need to be enforced.

[92] In the case of pharmaceutical products, which were not previously covered by property rights, Egypt has an additional grace period until 2005.

(e) It has established a system to review the legislation of member States in connection with intellectual property to ensure that countries abide by the agreement.

Egypt already has laws and revised laws related to specific IPR.[93] However, these existing laws cannot simply be revised or amended in order to comply with TRIPs for the following three reasons: (a) the level of protection of intellectual property stipulated by the agreement is much higher than can be provided through existing laws; (b) the agreement covers new forms of intellectual property, including, *inter alia*, geographic indicators and blueprints of integrated circuits; and (c) these laws were promulgated approximately 50 years ago and cannot keep pace with the rapid technological developments in property rights, particularly in the area of ICTs.

For these reasons, a new law, which reflects all of these dimensions and aspects of IPR in conformity with the agreement on TRIPs, has been drafted and forwarded to Parliament for approval.[94] On the institutional front, it emphasizes the need to establish both a fund to stabilize and balance the prices of medicines, and an institution to deal with TRIPs, namely, the Higher Council for the Affairs of Intellectual Property.

While the proposed law confirms the commitment by Egypt with regard to the agreement on TRIPs, it seeks to minimize the negative impact of the agreement on domestic pharmaceutical industries. Within that context, the salient features of the draft law are as follows: (a) to adhere to the lower statute of limitations as stipulated by the agreement on TRIPs with regard to the protection of patents in the field of medicines; (b) to restrict the protection of patents, thereby excluding those sectors deemed of vital national interest, particularly in the area of public health; (c) to establish a detailed system for obligatory licensing in the area of medicine and in a manner that does not discourage FDI; and (d) to set up rules and restrictions that limit price hikes or the unavailability of products that are protected by patents.

### 3. *Contracts*

Contracts in Egypt are equally governed by the Civil Code,[95] which cover all aspects of contracts, including forms of contracts, civil or administrative; basic elements of contract, namely, consent, object, cause and effect; and binding power. The Code defines juridical causes and limitations in terms of dissolution, nullity and annulment. Additionally, the capacities of the parties to a contract are clearly articulated for all classes and types of contracts.

Problems associated with contract enforcement are not attributed to the law per se, but rather to weaknesses in the legal system, particularly in terms of the time taken to settle disputes. For this reason, commercial arbitration has now been instituted and is gaining more ground despite the comparatively high cost of out-of-court settlements.

### 4. *State and corporate governance*

Egypt has been proactive in complying with the principles of good governance. With a view to sustaining development and growth, efforts to improve governance have intensified on four fronts, namely, transparency; predictability in macroeconomic policies and the regulatory system; accountability; and enhancement of the capacity of public institutions. Within the framework of the institutional building process, Egypt has made significant progress in a number of areas, namely: (a) by promoting private investments, both domestic and foreign, through the creation of an economic environment that is conducive to the private sector, thereby reaping high economic benefits; (b) by strengthening the financial sector through the creation of an enabling legislative environment that is largely aligned with international

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[93] Among these are Law No. 57 of 1939 relating to trademarks; Law No. 132 of 1949 in connection with patents and industrial models; and Law No. 354 of 1954 in connection with copyright.

[94] The draft law was submitted to Parliament for ratification during the current session November-August 2002.

[95] Articles 89 to 161 deal with the issue of contracts.

standards; (c) by encouraging private investments to create employment opportunities; and (d) by establishing the Social Fund to act as a safety net, particularly for the vulnerable.

Additionally, efforts have been made to improve Government efficiency and responsiveness. The State maintains a dialogue with the business community to seek its views, comments, suggestions and concerns with respect to draft laws and regulations.[96] Moreover, in recent years, the general public has been encouraged to actively participate in the democratic process of the political process with the establishment of political parties.

The decentralization of the administrative system has become a standing policy with a view to shifting local administration to local government with particular emphasis on aspects of environmental protection.[97] Parallel efforts are needed to bring about cultural changes through education and to raise awareness among the public.

Companies in Egypt are demonstrating continuous improvement in the area of corporate governance. Shareholder rights, particularly minority, are being given due recognition and protection. Principles of transparency, fair and equitable treatment of shareholders, and the respect of basic rights are largely manifested by the corporate sector.[98] As of March 2001, the Egyptian market comprised a total of 10,652 joint stock companies and 16 corporate partnerships limited by shares. Both corporate forms can be listed on the stock exchange. Moreover, the number of listed companies grew from 656 in 1992 to 1,110 in 2001. Listed companies are eligible for a tax exemption equivalent to the deposit rate of three months paid by the Central Bank of Egypt (CBE) on paid up capital.[99]

Companies are incorporated and monitored by the following laws:[100]

(a) The Companies Law (No. 159 of 1981) on joint stock companies, partnerships limited by shares and companies with limited liabilities, which are not allowed to issue shares and therefore cannot be listed on the stock exchange. The Companies Department, which supervises the implementation of the Law, has the power to deny applications for incorporation and can order the closure of a company that does not comply with orders within 15 days and does not submit a petition during the same period;

(b) The Law on Investment Guarantees and Incentives, also known as the Investment Law (No. 8 of 1997), promotes investment in specific economic sectors or industrial locations by granting income tax exemptions for 5, 10 and 20 years or, in the case of tax free zones, permanent exemptions. Companies incorporated under this Law are regulated by the General Authority for Investment (GAFI);

(c) The Public Business Sector Law (No. 203 of 1991) identified 314 public sector companies for sale to the private sector. In 1991, these companies were incorporated as joint stock companies and transferred to affiliates under 27 holding companies. These companies become subject to the Companies Law once 51 per cent of their stock is privatized.

Different laws govern securities markets and the securities industry. These are as follows:

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[96] In addition to the Federation of Chambers of Commerce and many other joint-venture chambers, as many as five business associations are actively participating in the formulation of laws and regulations.

[97] The Environment Protection Law (No. 4 of 1994) was promulgated for that purpose.

[98] *Report on the Observance of Standards and Codes ROSC: Corporate Governance Country Assessment - Arab Republic of Egypt*, the World Bank-IMF, August 2001.

[99] In 2000, domestic retail investors represented 51 per cent of the market, domestic institutional investors mainly mutual funds 22 per cent and foreign investors represented 27 per cent.

[100] A unified corporate law to govern all types of companies is being drafted in order to eliminate the complexity of these various laws.

(a) The Capital Market Law (No. 95 of 1992), which regulates the capital market, provides the framework and supervision of the stock exchange, and regulates the incorporation and operations of securities intermediation companies;

(b) The Central Depository Law (No. 93 of 2000), which supports shareholder record keeping, clearing and settlement.

Relevant company laws protect shareholder rights whereas contract or specific laws, particularly the labour act, environmental law or insolvency regime, protect stakeholder rights. Stakeholders, including bondholders, employee shareholder associations and environment protection societies, have access to the legal process to obtain redress for the violation of rights. Employees can establish an employee shareholder association (ESA) for the purpose of owning shares and distributing profits among members. Similarly, bondholders can act collectively by selecting a representative to maintain their interests in the company.

An assessment of the observance by the corporate sector to corporate governance principles was carried out in 2001, and highlighted a number of areas where corporate governance in Egypt needs strengthening.[101] This assessment can be grouped under the following six themes: (a) disclosure of ownership and control structures; (b) disclosure of financial and non-financial information; (c) training and capacity-building for regulators and the private sector; (d) the role and effectiveness of shareholder meetings; (e) the practices of managing directors; and (f) professional conduct of auditors. The assessment revealed that, out of 48 principles of corporate governance, 14 principles were observed, 25 principles were largely observed, 8 principles were materially not observed, and 1 principle was not observed.[102]

### 5. *Competition and investment*

#### (a) *Competition Law*

Despite provisions in various legislations that address basic anti-competitive behaviour, the issue of competition in Egypt has never been governed by a comprehensive legislation.[103] Recognizing the urgent need for such a legal framework, a draft competition law has been prepared by the Government and will be submitted to Parliament for approval in early 2003.

The proposed law applies to all persons and entities engaged in financial and economic activities, including trade, industry and services. Strategic entities that are owned or operated by the State to provide water, gas, electricity and petroleum in addition to other entities established by presidential decree are not subject to this law.

The draft law prohibits forms of practices that are regarded as anti-competitive, including the following: (a) decrease, increase or otherwise control of the purchase or sale prices of goods and services; (b) restrictions in the production, distribution or marketing of goods and services; (c) lack of market-sharing; and (d) restrictions in the arrangements with regard to the tendering process. The rules apply to mergers and acquisitions that are made by entities with a capital or turnover of 50 million Egyptian Pounds (LE) or more. The draft law stipulates that mergers are prohibited if they enable the merged entity to unilaterally set the

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[101] *Report on the Observance of Standards and Codes ROSC: Corporate Governance Country Assessment - Arab Republic of Egypt*, the World Bank-IMF, August 2001.

[102] Observed means that all essential criteria are generally met without any significant deficiencies; largely observed means that only minor shortcomings are observed, which do not raise any questions about the ability and intent by the authorities to achieve full observance within a prescribed period of time; materially not observed means that, despite progress, the shortcomings are sufficient to raise doubts about the ability by the authorities to achieve observance; and not observed means that no substantive progress toward observance has been achieved. Ibid.

[103] The legislations that prohibit unfair competition include Article 345 of the Penal Code of 1937; Law No. 241 of 1959; and the Commercial Law. B.A. El-Dean and M. Mohieldin, *On the Formulation and Enforcement of Competition Law in Emerging Economies: The Case of Egypt*, Egyptian Center for Economic Studies (ECES), Working Paper No. 60, September 2001, p. 22.

price of goods and services, affect the entry or exit to or from the market, and/or promote the undertaking of prohibited activities as set out by the law.

The draft law suggests the establishment of an independent competition commission and describes its structure, staff requirements and authority. Moreover, this law outlines the rights and mechanism with regard to enforcement, including penalties and sanctions. The commission is expected to establish a database and to conduct research and studies to reveal anti-competitive practices.

The delay in promulgating this law has affected the market in Egypt since consumers pay high prices for most tradable items, which indicates that companies have high mark-ups that are maintained in an environment of low competition. Furthermore, this has resulted in a low quality of production and a high cost of living for the population, particularly among the low-income groups. Additionally, the limited domestic competitive environment has negatively affected the capability of companies to compete in international markets where competition is both more intense and advanced.

This delay can be partly attributed to obstructionism by the private sector, which has a number of concerns with regard to a law on competition. Principally, these are that, under the guise of protecting competition, the Government could adopt a new form of State intervention; that the law could be open to abuse, particularly by companies that use it to charge competitors with unfair trade practices; and that the draft law does not adequately cover the informal sector, including smuggling activities.[104] Moreover, this delay has been encouraged by a growing private sector, which seeks monopolist position for fast gains and which therefore has a vested interest in obstructing a law that combats such monopolistic tendencies.

(b) *Investment Law*

The Investment Law is the fundamental legislation that governs investment incentives in Egypt. It was adopted in response to a broad effort by both the State and the private sector to reform the numerous and complex laws that governed commerce and investment. The investment guarantees covered by this Law include nationalization, administrative seizure or sequestration, pricing interference and determination of profits, rescission of licences, land ownership rights, and the right to import raw material and equipment directly or through intermediaries. The Law reduces import duties and provides exemptions from certain corporate law and labour law requirements, in addition to other exemptions from several taxes, including income tax, stamp duty and capital gains tax.

This legislative reform in the area of investment has resulted in a number of benefits, namely: (a) increasing private investment in targeted areas; (b) improving the competitiveness and productivity of new companies; (c) stimulating FDI by diverting funds away from less productive to more productive uses; and (d) cutting costs for both the State and potential investors through an automatic approval process rather than the lengthy and cumbersome process of the pre-reform era, which involved high-level investment committees.

The impact of investment incentives is clear. While the Law came into effect during only part of 1997, the largest increase in the number of new companies occurred in 1997 compared to other years. This surge is largely attributed to an improvement in administrative procedures rather than to fiscal incentives, which were similar under the previous legislation. Principally, in addition to cutting costs and saving time, the automatic eligibility and approval process of the Investment Law has removed the discretionary nature and arbitrary decisions of the earlier legislation. Moreover, the issue of transparency, with its clear focus on 16 eligibility criteria compared to the vague eligibility criteria under the former legislation, is an important incentive for both domestic investment and FDI.

### 6. *Institutions in other areas*

The Government plan for the period 1981-2000 reflected a macroeconomic policy that aimed to pursue social progress and develop the institutional and physical structures through incentives for production

[104] Ibid., p. 26.

and efficiency.[105] The plan emphasized learning from the experience of other countries in order to improve the institutional set up and to effect necessary reforms. Strong, regulating institutions have been created to become functional on prudential and technical grounds. Moreover, strong law enforcement agencies were deemed essential to implement these reforms and to help activate the role of financial markets in mobilizing savings and effectively allocating resources. Within this context, the Central Bank of Egypt (CBE), the Capital Market Authority (CMA) and the Egyptian Insurance Supervisory Authority (EISA) are the regulating agencies of the financial sector, which have been empowered by their respective laws to undertake their respective missions. Additionally, other institutions, including GAFI, have been created to facilitate, and thereby boost, domestic investments and FDI.

(a) *The Central Bank of Egypt*

The Banking Law (No. 101 of 1993) and the Foreign Exchange Law (No. 38 of 1994) empowered CBE as the regulating agency responsible for monitoring and supervising the national banking system and the assets and liabilities of each domestic bank with regard to the Basle Rules.[106] The Foreign Exchange Law allows all licensed banks in Egypt to deal in foreign currency and establish foreign exchange dealers. A single market for foreign exchange transactions was established, whereby banks and dealers determine the rates of foreign exchange according to the free market mechanism. CBE retains significant power to undertake remedial measures when provisions of these laws are violated. Moreover, given the full autonomy and the sole responsibility for the adoption and implementation of monetary policy, CBE plays an integral yet independent role within the national economy.

(b) *The Capital Market Authority*

The Capital Market Law (No. 95 of 1992) established CMA as an independent regulating and technical authority in charge of all matters related to the securities market. The market was organized as a means for medium- and long-term business financing, thereby complementing the short-term financing provided by the commercial banking system. The development of a capital market has been at the centre of attention of the reform programme given its pivotal role in mobilizing savings and allocating resources. Moreover, it is the primary source of capital formation and long-term financing, and paves the way for both domestic and FDI inflows. In Egypt, the role of the capital market is further boosted since it is an instrumental tool in the national economic policy. Chiefly, it extends the ownership of economic assets, thereby broadening the base of investors according to the privatization objectives.

The capital market lacked many of the market institutions that play an indispensable role in efficient and well-developed markets. Fundamental improvements were therefore introduced in order to build an infrastructure and to encourage the provision of these and other adequate securities related services.[107]

(c) *The Egyptian Insurance Supervisory Authority*

The Insurance Supervision and Control Law (No. 10 of 1981) is the enabling law for insurance market supervision, conduct and claims settlement, and for the monitoring of intermediaries. With EISA taking the lead, a plan was developed to reform the insurance sector. This Law was amended in 1998[108] to allow full private sector ownership in this sector, thereby ensuring full participation in the investment markets and the provision of long-term financing.

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[105] The level of Government spending, which is a clear indication of the macroeconomic policy, fell from 47 per cent of GDP in 1990 to 25 per cent of GDP in 1999.

[106] Developing nations are increasingly adopting standards formulated by the Basle Committee of Bank Supervisors, commonly known as the Basle Rules. These standards spell out the amount capital banks need to retain based on ratios that take into account the risk factor of assets.

[107] For instance, the two stock exchanges in Cairo and in Alexandria have been reorganized and modernized and have been unified as a single market that is linked electronically for real-time trading.

[108] It was amended by Law No. 156 of 1998.

The insurance market in Egypt is mainly composed of the Supreme Council of Insurance, EISA, the Insurance Federation of Egypt, a number of insurance companies, the Government Insurance Fund, which is a specialized reinsurance company, and insurance cooperative associations. The public sector maintains 73.3 per cent of the insurance market, while the private sector represents the remaining 26.7 per cent. Insurance companies and private pension funds are large institutional investors in the financial markets with a total investment that amounted to LE 20.5 billion in 2000/01.

(d) *The General Authority for Investment*

GAFI was established to enforce investment laws.[109] This agency has three principal aims, namely, to streamline and facilitate the investment process by reducing the time taken and the number of documents needed to incorporate a company; to simplify related procedures; and to deregulate business activities with a view to creating a competitive investment environment.

These new initiatives have removed most of the constraints that hampered the business activities with regard to investments in the pre-reform era.[110] Investment licensing requirements for private enterprises incorporated under the Companies Law have effectively been eliminated. For all other activities, including capacity expansion for existing firms, a registration process has replaced investment licensing. Moreover, registration for investment, which can no longer be refused, is now processed within a statutory period of two weeks. Additionally, all production and product mix licensing requirements have been eliminated. Private companies incorporated under the old investment laws, namely, Laws 43 and 230, have similarly benefited from a liberalization of investment. Furthermore, with the full deregulation of prices, the discrimination against private enterprises has disappeared. In addition to liberalizing investment and production licensing, measures were taken to phase out the public trading, marketing and distribution monopolies.

### 7. *Quality of the institutional reforms*

The issue of quality of institutions and of institutional changes is open to debate. While a number of analysts follow a pragmatic approach and tend to highlight positive results, others are on the pessimistic side and use current measures of institutional quality to pinpoint weaknesses and constraints. The State typically adopts the optimistic approach, while the private sector generally supports the latter argument. In Egypt, despite significant achievements as reflected by macroeconomic indicators, the private sector refers to recent surveys measuring the quality of institutions to support the argument that such quality is poor and that institutions therefore require further drastic changes.

A survey conducted by the World Bank in 2000 ranked Egypt as 63 among 90 countries in terms of the quality of the institutional environment.[111] Moreover, out of 155 countries, Egypt was ranked 100 in Government effectiveness, 102 in regulatory burden, 80 in rule of law, and 103 in graft.[112]

## C. THE IMPACT ON INVESTMENT AND GROWTH

### 1. *Economic growth*

The institutional reform in Egypt, though still incomplete, has contributed positively to economic growth by providing an enabling environment for the active participation of the private sector in economic

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[109] Within the context of investment laws, No. 43 of 1974 was amended by No. 230 of 1989 and then replaced by the new Investment Law (No. 8 of 1997).

[110] Under the old Investment Law (No. 230 of 1989), which governed foreign investment, and the Companies Law (No. 159 of 1981), which governed domestic investment, State intervention was extended to the rejection of investment proposal, expansion or change in product mix as an instrument to protect the public sector.

[111] Egypt scored 3.1 on a scale of 1 to 10 in the Corruption Perception Index, which was developed by Transparency International (TI) to measure the quality of the institutional environment. *Egypt: Social and Structural Review*, the World Bank, Working Paper No. 22397, June 2001, p. 29.

[112] Ibid.

development. Gross domestic product (GDP) grew in real terms over the period 1989-1999, rising from 4.8 per cent to 6.1 per cent (see table 1). This rate dropped to 5.1 and 4.9 per cent in 1999/2000 and 2000/01 respectively due to tight policy coupled with a global downturn.[113] Despite these effects, the economy has shown overall resilience, particularly in light of such adverse factors as the drop in oil prices and the temporary decline in tourism.

TABLE 1. EGYPT: SELECTED MACROECONOMIC INDICATORS
*(Percentages and ratios)*

| Indicators | 1989/90 | 1994/95 | 1998/99 | 1999/2000 | 2000/01 |
|---|---|---|---|---|---|
| Real GDP | 4.8 | 4.7 | 6.1 | 5.1 | 4.9 |
| Annual inflation | 21.2 | 9.3 | 3.8 | 2.8 | 2.4 |
| Fiscal deficit [a/] | (15.1) | (1.3) | (4.2) | (4.7) | .. |
| Current account [a/] | .. | 0.6 | (1.9) | (1.2) | (0.03) |
| Foreign debts [a/] | 157 | 54.8 | 31.7 | 28.5 | 27 |
| Total debts [b/] | 390 | 227.1 | 182.4 | 156 | 141.5 |
| Debt service ratio | 49.2 | 13.6 | 7.2 | 7.5 | 7.2 |
| Reserves/months of imports | 2.8 | 16.4 | 12.7 | 10.2 | 10.4 |

*Source*: *Quarterly Economic Digest: October-December 2001*, Ministry of Foreign Trade, 2001, vol. VII, No. 4.

a/ As a percentage of GDP.
b/ As a percentage of exports.

*Notes*: ( ) Indicates a negative percentage.
Two dots (..) indicate that data are not available.

Table 1 illustrates a positive economic performance, which implies a correlation between economic growth and institutional reform, especially in the second half of the 1990s. Given that most of the institutional reform, particularly in the fiscal and monetary sectors, was accelerated in the first half of the 1990s, it created a favourable environment for the participation of the private sector in the economy, thereby reflecting positively in the economic performance. The adoption of the Banking Law and the establishment of CMA, EISA and GAFI during the first half of the 1990s provided a catalyst for the participation of the private sector in the economy and boosted domestic and FDI inflows. This fostered economic growth during the second half of the 1990s.

Moreover, during this period, the sharp increase in private investment led to rapid growths in gross domestic investment. Table 2 indicates that the gross domestic investment as a percentage of GDP increased from 17.8 per cent in 1993/94 to 24.6 per cent in 1999/2000.

### 2. *Savings and investment*

In response to institutional changes and a stable macroeconomic environment, both private savings and investment increased significantly during the period 1995-2001. In 2000/01, they increased to LE 60.3 billion and LE 75.5 billion respectively (see table 2). Gross domestic savings averaged 18.3 per cent of GDP over the period 1993/94-2000/01, while gross domestic investment averaged 21.7 per cent of GDP over the same period, indicating an average investment-savings gap of 3.4 per cent.

The private sector is the driving force behind domestic savings. In response to the continuing institutional reforms, domestic savings increased from 16.5 per cent in 1993/94 to 19.1 per cent in 2000/01. The bulk of this expansion was accounted for by the private sector. Moreover, higher savings, particularly in the areas of agriculture and industry, enhance the surge in investment. Further institutional reforms at the

[113] The economic downturn was aggravated by the Asian crisis in late 1997 and 1998, and by the terrorist attacks on the United States on 11 September 2001.

sectoral level are expected to make the flows between savings and investment more efficient.[114] In this respect, the institutional reform is expected to increase annual per capita growth by 2.7-3.7 per cent. Additionally, privatization and reform of public enterprises are expected to increase corporate savings in the form of higher retained earnings by 2.1 per cent of GDP. Furthermore, reforms in the financial sector develop the banking, insurance and pension systems, thereby encouraging household savings.

TABLE 2. EGYPT: SAVINGS AND INVESTMENT
*(Billions of LE and percentages)*

| Indicators | 1993/94 (1991/92 prices) | 1996/97 (1991/92 prices) | 1999/2000 (1996/97 prices) | 2000/01 (Expected) |
|---|---|---|---|---|
| Real GDP at market prices | 148.8 | 172.5 | 301.6 | 316.4 |
| Nominal GDP at market prices | 175.0 | 256.3 | 336.5 | 364.9 |
| Gross domestic savings | 24.5 | 32.6 | 56.7 | 60.3 |
| | 16.5[a/] | 18.9[a/] | 18.8[a/] | 19.1[a/] |
| Gross domestic investment | 26.5 | 35.7 | 74.3 | 75.5 |
| | 17.8[a/] | 20.7[a/] | 24.6[a/] | 23.9[a/] |

*Source*: *Quarterly Economic Digest: October-December 2001*, Ministry of Foreign Trade, 2001, vol. VII, No. 4.

a/ As a percentage of GDP.

### 3. *FDI inflows*

Attracting FDI is the focal point of current policies in Egypt. Government policy has therefore concentrated on ways to remove the structural, institutional and legal impediments to foreign investment. Various laws have been approved to privatize public entities, including the postal service, public transportation, electricity supply and telecommunication; and to enable the expansion of build-operate-transfer (BOT) contracts, and build-own-operate-transfer (BOOT) contracts.

Capital flows during the 1990s were sporadically high, which indicates greater openness in terms of FDI and portfolio investment. Investment increased and contribution to capital formation expanded. Net FDI inflows to Egypt averaged almost $800 million per annum during the period 1990-1999, which was equivalent to 1.3 per cent of GDP (see table 3). In 1990, FDI amounted to $734 million, increasing to $1.5 billion in 1999, slightly more than double. This positive rise in FDI can be attributed to the fact that Egypt, which is at the crossroads to both European and Arab markets, represents the largest potential market in the region.

TABLE 3. NET FDI INFLOWS TO EGYPT, 1990-1999

| Indicators | 1990 | 1994 | 1999 | Total (1990-1999) | Mean (per annum) |
|---|---|---|---|---|---|
| Global FDI in developing countries (in billions of $) | 31.2 | 88.8 | 185.1 | 1039 | 103.9 |
| FDI in Egypt as a percentage of global FDI | 2.35 | 1.41 | 0.81 | 0.76 | 0.92 |
| FDI in Egypt (in millions of $) | 734 | 1 356 | 1 500 | 7 893 | 789.3 |
| FDI in Egypt per capita (in $) | 14 | 22 | 24 | 135 | 13.5 |
| FDI as a percentage of GDP | 1.7 | 2.4 | 1.6 | 13 | 1.3 |

*Source*: *Egypt: Social and Structural Review*, the World Bank, Working Paper No. 22397, June 2001, p. 26.

[114] There are four key institutions that are crucial to the development of private, long-term savings, namely, life insurance; pension schemes and social insurance; the capital market; and privatization.

### 4. *Privatization*

The privatization process in Egypt is proceeding in line with the national policy of promoting both domestic investments and FDI. This process is set to continue into the medium term, increasing private sector participation and stimulating growth. The total privatization effort has involved the sale of 185 public companies or 58.9 per cent of the original portfolio of 314 companies, which represents a revenue of LE 16.8 billion or 5 per cent of GDP.[115] Privatization has been more aggressively promoted in recent years with the sale or partial divestment of 115 companies.[116] Moreover, the scope of the privatization programme has increased the economic activity by the private sector through the ongoing divestment of the banking sector, including the scheduled privatization of public sector banks and insurance companies, and the ongoing downsizing of the civil service by 2 per cent annually.

A fundamental Government policy is to consolidate and extend the benefits of privatization by, *inter alia*, (a) persisting with strong macroeconomic policies; (b) accelerating structural reforms to boost the level of private capital flows in total domestic capital; (c) providing and improving technological, marketing and management techniques; and (d) increasing and diversifying manufacturing exports. These efforts are expected to increase FDI inflows, stimulate enterprise productivity, generate exports, help import critical management expertise and improve the quality of external financing.

### 5. *International trade*

The programme of trade reform in Egypt has forced far-reaching changes on an economy that has been operating behind high protection for over 30 years. The reform is composed of various elements, including liberalizing the trade regime; seeking multilateral liberalization through the implementation of WTO commitments; and positioning Egypt as an attractive and strategic base for FDI through regional free trade agreements with the European Union (EU) and the Common Market for Eastern and Southern Africa (COMESA), thereby promoting exports to these and other markets; and seeking other bilateral trade agreements.[117]

The reform programme in trade policy has focused on phasing out the non-tariff barriers. Additionally, the high import tariffs have been cut and the range between the lowest and the highest import rates has been narrowed.[118] Similarly, significant improvements have been made to trade regulations beyond those made to the tariff structure. These include the following: (a) changing import bans, which were once a key instrument in regulating trade; (b) improving port services and customs processing; (c) promoting competent agencies in the areas of customs administration, policy implementation, law enforcement and management;[119] and (d) simplifying procedures and reducing costs through sound management.

Within the framework of international commitments, the Government has implemented programmes to improve product standards, labelling and quality control; and has adopted legislation concerning anti-dumping measures and IPR. By following these programmes, Egypt has improved both its productivity and trade regime, which promote effective participation in the global economy.

### 6. *Managing a liberalized economy*

While maintaining flexible macroeconomic policies, Egypt has sought to reinvigorate structural reforms aimed at improving the management of the economy, thereby building on the gains achieved in the

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[115] *Quarterly Economic Digest: October-December* 2001, Ministry of Foreign Trade, 2001, vol. VII, No. 4.

[116] As of December 2001, 29 companies were sold outright to anchor private investors, 38 were majority sold through the stock exchange, 16 were partially divested, and 32 companies were sold through employee shareholder associations.

[117] In 1998, Egypt signed the Trade and Investment Framework Agreement (TIFA) with the United States, and bilateral trade agreements to establish free trade zones with both Tunisia and Turkey.

[118] The maximum tariff is currently 40 per cent, which has been progressively reduced. The tariff structure was established by Law No. 187 of 1986 and is based on harmonized system codes adopted in 1993.

[119] The competence of these agencies is measured in terms of quality control, product standards and the ability to collect and disseminate relevant information.

early 1990s. Relevant monetary and fiscal measures were implemented to reduce public borrowing, which helped the recovery of private credit, investment and growth. Moreover, these measures generated favourable results in three areas, namely, narrowing the balance of current accounts to $33 million in 2000/01; reducing inflation rate to a low level of 2.4 per cent in November 2001; and stabilizing international reserves. Table 1 illustrates the decline in foreign debt as a percentage of GDP from a high of 157 per cent in 1989/90 to 27 per cent in 2000/01. Similarly, foreign reserves in terms of months of imports increased considerably over the same period.

Private investment has responded positively to liberalization, and its role as the engine for growth is increasing. The evidence of renewed confidence is manifested in rising private investments, accelerated growth and continued participation by the private sector in infrastructure and utilities projects, which were previously dominated by the State.[120] The emergence of a strong private sector holds the potential for developing the domestic financial markets. Portfolio inflows and new instruments for long term financing are being developed with the aim of diversifying financial tools, thereby deepening the financial markets.[121]

## D. OBSTACLES TO THE REFORM PROGRAMME

Institutional constraints in Egypt remain relatively high compared to other developing countries. This can account for comparatively lower levels of private sector growth and FDI inflows in recent years. Cross-country comparisons indicate that business opportunities in Egypt are less attractive than in other developing countries. The business community in Egypt has cited a number of constraints and impediments that, in their view, impede the development of a business-friendly environment.[122] These institutional constraints exist in a number of areas, namely: (a) transaction costs; (b) bureaucratic system; (c) legal and regulatory systems; (d) settlement of commercial disputes; (e) human resources; and (f) macroeconomic sustainability. Other constraints, which are generally perceived as less significant, include difficulties in exporting goods and services, limited access to finance, insufficient local demand and problems procuring inputs.[123] Furthermore, most of these constraints are due to the weak enforcement of relevant laws and regulations rather than from the lack of such laws or deficiencies in the deregulation process.

### (a) *Transaction costs*

Transaction costs are high in Egypt, which affects productivity and drains economic growth.[124] Moreover, tax issues are perceived as major obstacles to business both in developing and developed countries. In Egypt, the high transaction costs for taxpayers are compounded by a perception of discretion and arbitrariness by the tax administration.[125]

### (b) *Bureaucratic system*

Within the context of administrating and enforcing economic laws, a bureaucratic system can be a major constraint if it lacks coordination among its different branches, has obsolete data management facilities and poor working conditions for its employees. Egypt has a poor rating in terms of bureaucratic

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[120] During the period 1993-2001, the private sector invested a total of LE 190.1 billion in the primary securities market. *Weekly Statistical Report*, Capital Market Authority (CMA), 7 March 2002.

[121] For instance, the capitalization of the securities market increased from LE 2.3 billion in 1986 to LE 119.8 billion in 2000. Ibid.

[122] *Impediments to the Private Sector Development in Egypt*, American Chamber of Commerce in Egypt (AMCHAM), October 1996.

[123] Other constraints, including corruption, were not considered a significant obstacle to private business.

[124] A survey conducted by ECES that covered costs in several areas, including telephone installation, imports, housing and financial markets, concluded that high transaction costs reflect institutional weaknesses in Egypt. L. Benham, *Improving Egypt's Economic Performance: The Extent of the Market is Limited by the Costs of Exchange*, ECES, Working Paper No. 13, June 1997, pp. 5-6.

[125] S. Tohamy, *Tax Administration and Transaction Costs in Egypt*, ECES, Working Paper No. 33, November 1998, p. 29.

quality, law and order, and corruption.[126] The civil service staff is generally underpaid, unmotivated and reluctant to perform its duties. Moreover, it lacks understanding of the overall policy framework and has little decision-making power. These shortcomings create opportunities for corruption and other abuses.

In the short to medium term, the quality of the bureaucratic system can be improved through on-the-job training with a clear process of career planning and simplified administrative procedures. Efficiency can be increased at a reasonable cost by implementing more aggressive civil service reforms and rehabilitation programmes.[127] In the long term, however, more qualified personnel must be recruited with a payment scale that is competitive with that of the private business sector.

(c) *Legal and regulatory systems*

The legal system is characterized by deficient and weak law enforcement that hamper business competitiveness and efficiency. Moreover, complex laws in the area of labour are a major deterrent to business. The high level of job protection in the formal private sector and the policy of guaranteed lifetime employment in the public and Government sectors impair personnel management and labour mobility.

The complexity of the regulatory system is compounded by problems of overlapping authority, sectoral imbalances and central and local regularity codes. Despite major streamlining of investment procedures, and on the basis that the State must retain the administration of the market, all non-industrial activities are subject to complicated procedures for approval by the concerned ministries.

(d) *Settlement of commercial disputes*

The lengthy process in settling disputes and the lack of judicial capacity hinders progress. There is therefore a need to establish commercial courts in Egypt that are specialized in dealing with corporate litigations. This arrangement is less costly in the long term than commercial arbitration, which is currently the only alternative.[128]

The main reasons for disputes are bankruptcy, broken agreements, problems of tax authority and quality of supplies.[129] Delays in court proceedings can be attributed to an insufficient number of judges, poor remuneration of legal staff, poor court facilities and cumbersome procedures. These contribute to a poor clearance rate.[130] The judiciary system is therefore unable to adequately govern business transactions, including settlement of disputes and enforcement of contracts, and to protect consumers and private property rights. This negatively impacts corporate behaviour in the following ways: (a) it limits contestability and thus efficiency; (b) it inhibits corporate growth since contracts binding individual investors are more difficult to uphold; (c) it increases project risk; and (d) it hampers the development of financial systems.

(e) *Human resources*

The scarcity of skilled human resources is a major constraint to business. In Egypt, the private sector has been slow to introduce modern techniques in the areas of quality control, marketing, packaging,

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[126] D. Madani and J. Page, *Global Rules for Business: Challenges to Firm Competitiveness and Opportunities for Success*, ECES, Working Paper No. 43, October 2000, p. 18.

[127] An early retirement system for civil servants similar to the system of the public sector companies can be an effective tool in this respect. The private sector needs to bear most of the cost involved through payments for the services provided by various State institutions.

[128] In 2000, arbitration represented less than five per cent of all cases of commercial disputes. Moreover, the average time needed to resolve disputes in court was four and half years compared to one year for out-of-court settlements.

[129] Almost two thirds of all disputes were between private firms, while disputes between the private sector and Government bodies represented 22 per cent of the total.

[130] In Egypt, the clearance rate, or the percentage of filed cases that are actually resolved, is 36 per cent compared to 80 to 100 per cent in other countries. *Egypt: Social and Structural Review*, the World Bank, Working Paper No. 22397, June 2001, p. 33.

distribution, guarantees and after-sales servicing. This is mainly due to an education system that is largely insensitive to the actual needs of the labour market, and to a labour force that is semi-literate. Within this context, the most critical issue is the absence of career development programmes within organizations, including organizational assessment of human resources, self-assessment, career goal planning and advancement and opportunities in employment.

Given that many establishments in Egypt tend to ignore the career planning process, productivity and organizational effectiveness have deteriorated. Consequently, related problems have emerged, namely, alienation by employees, less job satisfaction, stagnation of the organization in terms of conceptual development and a rise in the migration of skilled labour to other countries, commonly referred to as the brain drain.

(f) *Macroeconomic sustainability*

Predictability in policy-making is related to macroeconomic sustainability. Moreover, the macroeconomic environment deeply affects private sector confidence. In Egypt, the rapid accumulation of domestic public debt, caused in particular by an exponential growth in the population, is expected to continue to rise in the medium term, thereby hindering private investment.

Confidence is further hampered by a limited access to information. The average entrepreneur in Egypt is able to obtain only partial information on forthcoming policy changes. This has a negative impact on new investment. Obtaining such information is very complex since Government institutions are not adept at generating the briefing that is needed to support investment decisions. Furthermore, participation and access to information are related to the size of the company. Large private corporations have better contacts with policy makers than small enterprises. Moving from a protected, planned economy towards a market-driven one promotes competition and therefore provides incentives for the private sector to seek information in a timely and regular manner. Efforts by the State to foster macroeconomic stability can succeed only if the private sector is confident that the policies in place are sustainable and if it is privy to policy changes.

# IV. CASE STUDY: THE SYRIAN ARAB REPUBLIC

## A. INTRODUCTION

This case study analyses the economic reform in the Syrian Arab Republic and the attempts to promote socio-economic development in light of global changes.[131] The Syrian Arab Republic has opted for a gradual approach towards the implementation of economic reform in order to maintain socio-economic stability, avoid inflation shocks and stabilize the balance of payments and the balance of trade. The main focus is therefore on the reform of the public sector rather than on the transfer of ownership of public sector assets to the private sector. This reform is in line with the national policy of promoting both domestic investments and FDI by modernizing various sectors, including agriculture, industry, commerce and services; by building and improving the infrastructure; and by creating an adequate legal and regulatory environment.

While privatization is not a principal priority in the economic reform, the expansion of the private sector is being achieved mainly through operations and management contracts with major capital expenditures, commonly known as green field projects. However, there is a clear understanding that economic reform must be linked to the long-term plan for socio-economic development. This can only be achieved by increasing the efficiency of corporations and by allocating economic and human resources aimed at fostering a healthy environment for investment. Private investments can be encouraged by, *inter alia*, establishing a stock market to attract potential investors; building large companies in different sectors; and supporting SMEs. The reform process in the Syrian Arab Republic is particularly challenging since it involves replacing obsolete institutions that no longer respond to the needs of the country with adequate and proactive institutions.

## B. INSTITUTIONAL REFORM IN THE SYRIAN ARAB REPUBLIC

The main aim of the Government is to create an economic environment where both public and private sectors operate in a competitive environment with more facilities being granted to the private sector through institutional reforms. In this respect, the Government has enacted a number of necessary laws and regulations over the past few years to promote the expansion of the private sector, thereby promoting domestic and foreign business development and impacting economic growth. In general, the immediate priorities focus on improving the investment environment, reforming the financial and banking system, and reforming the foreign trade sector. The salient features of these issues are provided below.

### 1. *Economic reform*

Creating a favourable investment climate in the Syrian Arab Republic has gone hand in hand with the gradual economic reform policies adopted since the late 1980s.[132] The principal objectives of this reform are twofold, namely:

(a) At the macroeconomic level, efforts have concentrated on finding a balance between production, consumption, savings and investment; stabilizing economic growth in order to control inflation, thereby minimizing adverse social effects; and combating unemployment through programmes that create new job opportunities;

(b) At the sectoral level, the focus has been on addressing specific problems facing different sectors in the economy, particularly agriculture and industry, in order to achieve a more balanced growth and development.

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[131] There is an increasing awareness in the Syrian Arab Republic that the fundamental changes at the global level pose serious challenges for the economies of the developing countries, particularly given such dramatic changes as the collapse of the former Soviet Union, and the technological advances in information and communication technologies (ICTs).

[132] The reform process gathered momentum after the collapse of the former Soviet Union, which prompted most socialist countries to transform their economies into market economies.

Additionally, policies have centred on ways to attract investments from the local private sector, Syrian expatriates with footloose capital, and foreign capital, both regional and international. In an effort to motivate potential investors, the State has sought to focus on the benefits of engaging in business activities in the country. These include the following: (a) political stability; (b) protection of private property; (c) strategic geographic location of the country between Europe, Asia and Africa; (d) availability of natural resources, including oil, gas and phosphate; (e) strong agricultural base with such crops as cotton, wheat, vegetables and fruits; and (f) adequate infrastructure in the areas of industrial zones, transport networks, communications and electricity.

### 2. *Property rights and IPR*

Property rights in the Syrian Arab Republic are governed by the provisos of the Civil Law, which cover all aspects and forms of property rights.[133] Moreover, the Rent Law guarantees the legal protection of property in the area of leased land and real estate.

However, within the context of a global, knowledge-based economy, the focus has shifted from the material protection of property to the protection of IPR. There is therefore an urgent need to provide due protection, particularly given the increase in international trade. This issue is especially relevant to the Syrian Arab Republic in light of the negotiations with WTO. Additionally, there is a need for institutional reform in other key areas, including competition, corporate laws and corporate governance.

### 3. *Investment and taxation*

#### (a) *Investment Law*

The enactment of the Investment Law (No. 10 of 1991) represented a significant step in turning from a centralized and guided economy into a decentralized one with a greater role for the private sector. This has given the economy more flexibility in production and pricing decisions, and has created a competitive environment between the public sector and the private sector in both production and marketing. The most significant incentives provided by the Law include the following: (a) local, regional and foreign investors are offered equal access and privileges; (b) projects established under the Investment Law can import various inputs deemed necessary to build or operate these projects;[134] (c) these inputs are exempted from fiscal and municipal taxes and customs duties;[135] (d) exemption from income tax for seven years from the start of the investment or actual production launch, according to the nature of the projects; and (e) foreign investors have the right to transfer annually all profits realized from their investment projects provided that the investment funds were in foreign currencies and invested in accordance with the provisions of the Law.

#### (b) *Amendments to the Law*

Over the course of the 1990s, results indicated that the Investment Law had failed to attract significant FDI inflows. This created a deep conviction of the necessity to amend the Law with the aim of further encouraging both foreign and Arab direct investment. Consequently, the Government promulgated amendments to the Law with the following incentives:[136]

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[133] Additionally, the Syrian Arab Republic issued a legislative decree ratifying the joining of the Multilateral Investment Guarantee Agency (MIGA), which promotes FDI into emerging economies by offering political risk insurance to investors.

[134] These inputs include machines, vehicles, equipment, tools, cars, buses and minibuses needed to operate these projects in addition to other materials needed to construct, expand or develop them. Paragraph A of Article 11 of the Investment Law No. 10 of 1991.

[135] These exemptions apply provided that the imports are exclusively used for the relevant project and that they are not sold or given away to another party without prior agreement by the Supreme Council for Investment and after settling all taxes and duties due on them. Article 12 of the Investment Law.

[136] The amendments were part of the Legislative Decree No. 7 of 2000.

(a) To authorize Arab and foreign citizens to own and exploit land and real estate needed to establish and operate projects in strategic sectors, including agriculture;

(b) To offer exemptions as stipulated under other laws of the Syrian Arab Republic upon the expiration of the exemption period under the Investment Law;

(c) To extend the founding period from three years to a maximum of five years;[137]

(d) To promote and offer further incentives to those projects that build strategic and vital projects, increase national income and create new jobs, thereby supporting the development of the national economy;[138]

(e) To allow a partial exchange of foreign deposits into local currency at Syrian banks according to the rates effective in neighbouring countries; and to allow exporters to keep a percentage of export revenues in foreign currency higher than the percentage stipulated under the current currency laws;[139]

(f) To promote equal treatment between joint venture companies and the new, private companies by exempting the latter from stamp duty;

(g) To ensure the safety of investments and permit Arab and foreign investors to transfer the net value of their projects out of the country in the case of liquidation.

(c) *Taxation*

In the area of tax, the Government is working on a draft to amend the current law. Foremost among its objectives, this draft stresses the need for equality, thereby taking into account the marginalized and poor; and for taxation to cover income from activities undertaken both within and outside the country. In order to encourage the establishment of holding companies that raise their stocks for public underwriting, the income tax has already been fixed in both the public and private sectors at 25 per cent of net profits.

### 4. *Commercial Law*

Advances in S and T and the increasing role of e-commerce in the global, knowledge-based economy pose a challenge for the Syrian Arab Republic. There is an urgent need to amend the provisions of the Commercial Law, which was enacted over 50 years ago and cannot keep pace with the rapid technological developments in property rights, particularly in the area of information and communications technologies (ICTs). The Government is therefore currently working on a draft law that better reflects both the evolving commercial environment and ongoing investment needs. Within that context, a revised law must aim at the following:

(a) To take into account the latest developments in commercial activities, including technological advances, and update all relevant terminology;

(b) To harmonize the provisions of the Commercial Law with those of the Civil Law, particularly in the area of commercial mortgages;

(c) To establish an independent commercial register in civil companies;

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[137] Results from the 1990s indicated that certain projects needed more than three years to be established.

[138] These incentives include an additional two years to the exemption period for projects whose exports exceed 50 per cent of production during the original exemption period; for projects that protect the environment; and for projects that promote investment in less developed regions in the country, including Ar Raqqah, Al Hasakah and Dayr az Zawr.

[139] Investors have the right to open accounts in foreign currencies at the Commercial Bank of Syria and deposit their export revenues in foreign currencies in order to settle all expenses incurred by their projects.

(d) To facilitate the establishment of associations of capital, including anonymous companies and those of limited responsibility, by encouraging the capital of certain companies to be paid in foreign currency;

(e) To elaborate the provisions with regard to companies, particularly holding companies, that are established under the Investment Law and its amendments.

### 5. *Monetary authority and banking institutions*

Reform of the banking sector is the cornerstone of the economic reform process in the Syrian Arab Republic. During the past two years, concrete progress has been achieved in terms of financial and banking reforms. Great efforts have been made in the legislative and organizational fields to help the allocation of financial resources in various sectors, including industrial, agricultural and tourist. The Government has recognized the need to improve public banks, particularly in terms of competence and administration. National policy has therefore focused on modernizing and developing the banking sector and the banking infrastructure with the principal aim of aligning the domestic banking sector to international norms and standards. Other key aims include the following: (a) to stabilize the balance of payments and the balance of trade; (b) to increase foreign currency reserves; (c) to enhance prudential financial planning; (d) to increase investment and promote exports; (e) to promote the role of the Central Bank and enhance its independence; (f) to establish private and joint venture banks, and build the reputation of public banks to enhance their competitiveness once private banks are established; (g) to increase the salaries of employees in the banking sector; (h) to draft legislations to cover banking specialization; (i) to implement strategic merger policies; and (j) to improve and extend banking services, including insurance and real estate.[140]

Additionally, the reform aims to provide the monetary authority with sufficient autonomy and responsibility to undertake monetary policy effectively and efficiently, particularly in the areas of credit allocation, bank activities, interest rates and bank reserves.[141] Moreover, the reform seeks to extend the function of the Central Bank, providing it with a supervisory role over the monetary authority. Within the framework of these monetary reforms, the Government has issued legislative acts to activate the banking sector, thereby paving the way for the participation by the private sector, both domestic and foreign. The salient legislative acts in this area include the following:

(a) Order No. 793 of 2000 regulates the establishment of banking institutions within the free zones to finance various commercial and industrial activities and to provide investors in the free zones with banking services;[142]

(b) Decree No. 508 of 2000 established the General Institution of Investment Bank, which aims to perform all the banking activities resulting from previous legislative acts in the areas of investment, tourism and agriculture;[143]

(c) Law No. 28 of 2001 was enacted to allow the establishment of banks either in the form of private companies or in the form of joint venture companies with the public sector owning at least 25 per cent of the capital;[144]

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[140] The Real Estate Bank and the Commercial Bank of Syria are coordinating to introduce automated teller machines (ATMs) to various cities; and the Savings Bank plans to issue credit cards. Foreign credit cards, which are monitored by the Commercial Bank of Syria, have been used in the Syrian Arab Republic since 1999.

[141] The aim is to increase bank deposits by an annual 4.6 per cent and bank lending by 6.7 per cent.

[142] There are currently five banks operating in the free zones of the Syrian Arab Republic. Money transfers that are performed in these zones either by Syrians or foreigners are not subject to any supervision or control.

[143] The General Institution of Investment Bank is financially and administratively independent and supersedes the mechanisms that existed under Legislative Order No. 186 of 1985, which concerned tourist investment, Legislative Decree No. 10 of 1986, which governed agricultural investment, and the Investment Law (No. 10 of 1991) and its amendments.

[144] The Law allows foreign citizens to be among the founders of these banks and own a part of the stocks provided their shares do not exceed 49 per cent of the capital.

(d) Law No. 29 of 2001 introduced bank secrecy, whereby banks operating in the Syrian Arab Republic cannot divulge the name or value of a bank account without the written consent of the depositor except in the event of a lawsuit in which case such information can be subpoenaed;

(e) Law No. 23 of 2002 was enacted to promote private banks and establish the Council of Currency and Loans whose objectives are to organize the currency and credit institutions and coordinate their activities in line with the economic policies of the State.[145] Within this context, the aims of the Council are as follows: (i) to develop the financial and monetary system to meet the needs of the economy; (ii) to supervise the banking sector;[146] (iii) to stabilize exchange rates and liberalize exchanges between currencies; (iv) to maintain the purchasing power of the population; (v) to explore other resources of finance in order to increase national income; and (vi) to issue a quarterly report with regard to the monetary and banking developments and submit it to the Minister of Economy and Foreign Trade.

The Council of Currency and Loans has enjoyed a degree of success, particularly in developing the monetary system, stabilizing the national currency and assisting the Central Bank to recover full authority as the executive monetary power. However, there is a need to clearly define the relationship between the Council and the Central Bank, particularly in terms of conducting monetary policy. Moreover, the monetary authority needs more independence from the State in order to undertake its activities more competently and effectively, including, *inter alia*, planning suitable credit policies that reflect ongoing requirements, managing interest rates and defining strategies with regard to public borrowing.

Within that context, the Government must settle loans due to the Central Bank rather than freezing such loans or discharging those obligations through long-term treasury bills. This enhances confidence in the macroeconomic policies of the State. Borrowing costs can be reduced by reducing banking commissions;[147] by standardizing these commissions among all banks; and by eliminating the stamp duty on credit bonds and bank account statements.

Additionally, there is an urgent need to formulate and implement sound monetary policies with the following aims: (a) to adopt a unified exchange rate for Syrian pounds against all foreign currencies in order to control the foreign trade transactions;[148] (b) to establish a public company for currency exchange, which supports the role of the Commercial Bank of Syria, defines the volume of the daily movement of foreign currencies and sets up outlets to facilitate the exchange of foreign currencies for the general public and tourists; (c) to establish a stock market to protect investments, facilitate the transaction of stocks and encourage active participation by the private sector in the development process; (d) to reduce interest rates on bank deposits while maintaining a reasonable profit margin for banks; (e) to harmonize methods of calculating interests; (f) to harmonize the lending standards among all public banks with the exception of the Agricultural Bank in order to promote internal loans and prepare the public banks for competition with private banks;[149] (g) to remove administrative restrictions on the ceiling of loans given to the private sector and facilitate the bureaucratic procedures required for such loans; and (h) to offer more flexibility to bank administrators, particularly with regard to outsourcing to local or foreign experts.

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145 The Council of Currency and Loans plays the role of State Commissioner and comprises the Governor of the Central Bank; the Deputy Governor; the President of the Planning Council; three experts in the fields of currency, loans and banking; and deputy ministers of the Economy and Foreign Trade, Finance, Agriculture and Industry.

146 This supervision covers investment portfolios, liquidities and solvencies of banks and can be achieved by activating the role of the State Commissioner at the Central Bank and supporting it by employing competent managers and by setting a new instruction system.

147 These commissions are currently as high as 4.5 per cent for certain loans.

148 The Ministry of Economy is tackling this issue and is taking measures to gradually reach a unified exchange rate system. Foreign currencies are currently being bought at the rates that apply in neighbouring countries.

149 Agricultural loans are currently confined to the Agricultural Bank, whose role is being revised in light of the drive to promote private commercial and investment banks. For instance, the Legislative Decree No. 508 of 2000 stipulates the establishment of the Investment Bank with the task of providing banking services to agricultural and tourist projects.

### 6. *Foreign trade sector*

Cognizant of the key role played by foreign trade in activating and developing the economy, the Syrian Arab Republic is gradually liberalizing foreign trade in order to narrow the gap in the balance of trade. The reform programme in this sector aims to promote Syrian exports by improving quality, reducing costs and increasing diversification; and to modernize the economy through the transfer of technologies that have been adapted to local requirements.

In the area of exports, the Government recognizes the need to eliminate the constraints, obstacles and financial burdens that currently impede Syrian exports.[150] Moreover, while the Government is exploring ways to eliminate the import licence altogether, a number of liberalizing measures have already been adopted, namely, imports within the framework of the Arab Free Trade Area (AFTA) are dispensed from import tariffs; and the private and joint venture sectors can import materials and goods that were previously reserved to the public sector, or that were prohibited to protect local production. The new concept of protectionism is based on customs duties rather than on prohibition. Additionally, the Ministry of Economy and Foreign Trade is seeking to eliminate administrative constraints imposed on import and export activities, including the removal of the supreme committees that monopolize all the decisions with regard to foreign trade.[151]

While still in its infancy, the structural reform of the trade sector has already generated some favourable results. Principally, the private sector share in foreign trade has increased to approximately 60 per cent.

### 7. *Quality of the institutional reforms*

The institutional reform in the Syrian Arab Republic is still being implemented. The priority so far has been given to the reform of the Investment Law, the monetary and financial institutions and those related to the trade sector, where substantial progress has been made. However, given the early stage of reform, it is still premature to measure the profound implication of these reforms and therefore to analyse their quality.

## C. THE IMPACT ON INVESTMENT AND GROWTH

### 1. *Economic growth*

The success of the economic and institutional reforms in the Syrian Arab Republic has been mixed. While macroeconomic policies aimed at keeping the inflation rates under control have succeeded, the need to control unemployment is becoming more urgent and is turning into a pressing concern for policy makers. The Government has therefore allocated an annual budget of $200 million to assist SMEs, thereby promoting their production capacity and creating new employment opportunities.

Additionally, while efforts to change the production structure in the industrial sector have been largely positive, trials to implement new marketing policies for Syrian products have shown limited success. However, there is a great potential for growth in this area given the increase in competence and competitiveness through the liberalizing measures of the structural reforms in foreign trade. The Government therefore hopes to reap the benefits of this reform as imported inputs become cheaper and export opportunities improve.

Furthermore, reforms in the monetary authority and banking institutions are set to provide more financial facilities to the private sector, particularly in terms of facilitating loans, which significantly impacts

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[150] The Legislative Decree No. 15 of 2001 removes the preconditions for an export licence, including adjunctive taxes and duties.

[151] The Government has activated agricultural investment by facilitating the import of agricultural inputs to assist farmers market their crops and to encourage industrialists to receive these crops at international prices.

economic growth. The development of the banking sector further improves the investment environment by promoting the financing of trade.

However, the economic and institutional reforms have only recently been implemented. It is therefore premature for an empirical analysis of the impact on the economy. The economy is still highly dependent on the performance of the two most important sectors, namely, agriculture and oil. In 1999, these two sectors represented more than 45 per cent of GDP.[152] Consequently, economic growth has fluctuated according to the performance of these two sectors. The fluctuation in the agricultural sector is mainly attributed to the amount of the rainfall; and changes in the oil sector are closely linked to developments in international oil markets.

The GDP growth rate ranged from a negative growth rate of 1.9 per cent in 1999 to a positive growth rate of less than 2.5 per cent in 2000 and an estimated 3.5 per cent in 2001.[153] Additionally, the rate of investment as a percentage of GDP, reached 22 per cent in 1999. However, this percentage needs to be increased in order to boost economic growth. Within that context, the Government has sought to improve the investment environment by enacting new laws and regulations in order to encourage private investments, particularly FDI.

### 2. *International trade*

Acting on a deep conviction of the importance of pan-Arab cooperation, the Syrian Arab Republic is committed to activate bilateral trade relations with other Arab countries. These relations aim to foster regional production processes and socio-economic development in such a way as to promote new industries and products that are based on new investments. Moreover, there is a strong belief that Arab capital, whether expatriate or otherwise, needs to be invested in the Arab region rather than flowing into non-Arab countries.

Additionally, the Government is proactive in building trade bridges with other regions of the world. The Syrian Arab Republic is currently negotiating with the EU, its principal commercial partner, to conclude an association agreement that is expected to replace the cooperation agreement signed between the two parties in 1977. This association agreement aims at establishing a free trade area between the Syrian Arab Republic and the EU within the framework of the Barcelona Process.[154] Furthermore, within the context of the global trade system, the Government extended an official application to join WTO in 2001.

## D. OBSTACLES TO THE REFORM PROGRAMME

The economic reform programme in the Syrian Arab Republic derives its momentum from a strong political will and from a deep conviction of its importance at both the public and private levels. However, the reform programme is facing a number of challenges and obstacles that differ from those of other developing countries. This is largely due to the important social and economic role played by the public sector. While privatization has been widely implemented in many countries around the world, it is still not a priority issue in the Syrian Arab Republic.

The obstacles in the reform process therefore relate more to macroeconomic difficulties than to hindrances in institutional changes. While some significant results have been achieved in the Syrian Arab Republic with respect to macroeconomic stability, an enabling and competitive institutional environment is widely acknowledged as an indispensable and complementary condition for high and sustainable growth. Achieving a balance between economic requirements, which call for much needed changes in the institutional set up, and social requirements is the most critical challenge facing the Government.

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[152] "Syria at a glance: 2002-03", *Country Report*, The Economist Intelligence Unit (EIU), August 2002, p. 5.

[153] *Survey of Economic and Social Developments in the ESCWA region, 2000-2001* (E/ESCWA/ED/2001/7), chapter II.

[154] The Barcelona Process established the Mediterranean Free Trade Area.

Another challenge lies in the approach of economic pluralism, which has been applied in the Syrian Arab Republic since the 1970s. According to this approach, public companies and private or joint venture companies operate under two sets of regulations. While there is a growing conviction that the public sector must be restructured along the lines of a free and competitive system, the reform process is still in its infancy. Given that it is therefore premature to evaluate results, obstacles can arise if there is a perception that the benefits of these changes do not outweigh the efforts involved in institutional reform. The economy, which has operated under protectionist policies for several decades, is now preparing to enter a more liberalized, competitive environment. This radical change inevitably generates additional difficulties, particularly in terms of improving performance and maximizing productivity. However, this programme of reform represents a vital opportunity for sustainable economic growth in the Syrian Arab Republic.

## V. POLICY RECOMMENDATIONS

In general, there is a need to accelerate institutional reform in the ESCWA region, which must aim to be compatible with institutional schemes in other regions. Moreover, local institutions need to be more responsive to global economic changes. Institutional reform in ESCWA members must therefore be expedited in order to catch up with other developing countries.

### A. EGYPT

In Egypt, while significant results have been achieved in macroeconomic stability and credibility, a great deal of structural reforms is still needed to achieve an acceptable level of sustainable economic growth.[155] The following points serve to outline the background against which future action needs to be based:

(a) The economic reform programme must address the institutional framework since it is central to the success of the structural adjustment. The goal is to improve the overall efficiency and productivity of the economy through institutional support of market activities. The cost of change and its social implications must be given due consideration in order to properly manage the transition process and to ensure full command of the elements of success;

(b) The implementation of laws, regulations and relevant policies require the strengthening of Government capacity for effective governance. Within this context, the quality of management is likely to become the single most important factor in promoting sustainable human development;

(c) Promoting good governance is a matter of renewing the spirit of civic engagement in all aspects of public affairs. The Government must therefore encourage private participation aimed at identifying and prioritizing problems, which further strengthens the process of legislative reform, policy formulation and decision-making;

(d) The information and decision support systems at both the local and national levels need to be established and/or strengthened. Moreover, there is a need to ensure that NGOs and the private sector participate in the planning process;

(e) The Government must take into consideration the challenges posed by the global economy. Within this context, there are three basic concepts, namely, degree of State intervention, governance, and globalization;

(f) There needs to be a timely enforcement of contracts and a framework to enable swift settlements of commercial disputes in order to ensure the success of institutional reform. The Government must consider ways and means to expedite the settlement of commercial disputes by establishing specialized commercial courts.

### B. THE SYRIAN ARAB REPUBLIC

The key areas that need to be dealt with in formulating sound strategies in the area of reform in the Syrian Arab Republic include the following:

(a) The Government needs to issue a specific law for property right, including IPR. Moreover, there is a need for institutional reform to be formulated and implemented in other vital areas, namely, competition, corporate laws and corporate governance;

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[155] According to a study by the World Bank in 2001, Egypt ranked low in terms of an environment that is conducive to business. *Egypt: Social and Structural Review*, the World Bank, Working Paper No. 22397, June 2001, p. 29. Additionally, the Institutional Investor's Country Credit Ratings ranked Egypt significantly below Thailand, Chile and, to a lesser extent, Argentina. A. Galal, *Can Egypt Grow Without Institutional Reforms? If Not, Which Institutions Matter Most?*, the World Bank, August 1995, p. 8.

(b) The Central Bank must be given more independence, particularly in its role as State Commissioner. Moreover, the Government needs to define a clear relationship between the Central Bank and the Council of Currency and Loans in terms of conducting monetary policy;

(c) There is a need for a prudent monetary policy that allocates the available financial resources among different sectors and according to the priorities of the national economy, and that performs efficient control on the different uses of loans and funds to create a suitable environment for socio-economic development;

(d) Local banks, both in the public and private or joint venture sectors, must be encouraged to increase their solvency and widen their services, thereby raising profits and increasing competitiveness. Additionally, there is a need to adopt international standards of accountancy in order to enhance both the transparency and the quality of financial statements;

(e) The Government must encourage mergers among smaller public banks to form bigger banks with powerful capitals that can be more competitive and better cater to the changing needs of their customers;

(f) There is a need to establish a general regulation for all banks that clearly defines threats, guarantees and the general principles of lending.

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