



# THE ROLE OF MICRO AND SMALL ENTERPRISES IN EGYPT'S ECONOMIC TRANSITION

Hafez Ghanem



**Hafez Ghanem** is a senior fellow in the Global Economy and Development program at the Brookings Institution.

*Acknowledgements:*

I would like to thank Homi Kharas, Ehab Abdou, Bernard Funck, Djavad Salehi-Isfahani and Kei Sakamoto for comments on an earlier draft, and Kirsten Gilbert for editing the final version of this paper.

*Abstract:*

Past growth patterns in Egypt did not benefit the vast majority of the population and thus contributed to the revolution of January 25, 2011. This paper argues for a new economic vision based on the concept of inclusive growth. Support for youth entrepreneurship and small businesses would be central for the success of an inclusive growth strategy. The paper analyses economic developments in 10 years preceding the revolution and shows how a system of crony capitalism left millions of people socially and economically excluded. It uses results from enterprise surveys to analyze the problems facing small businesses and youth entrepreneurs. It proposes a two-pronged strategy to develop and modernize the small enterprises sector in Egypt: regulatory and institutional reforms to create a conducive environment for small business, and specific interventions to support small enterprises and develop youth entrepreneurship.

## **CONTENTS**

Introduction .....	1
Political Economy Background: Bumpy Transition and Deteriorating Economy.....	2
Pre-Revolution Economic Developments: High Growth and High Discontent.....	4
How Did the 2004 Reforms Affect the Middle Class? .....	8
Weak Governance and Youth Exclusion .....	11
The Egyptian Micro and Small Enterprise (MSE) Sector.....	13
Constraints Facing MSEs .....	17
Policy Implications.....	20
Conducive Macroeconomic Environment .....	21
Targeted Interventions to Support MSEs and Young Entrepreneurs .....	23
Bibliography .....	25

**LIST OF FIGURES**

Figure 1: Egypt - Recent Trends in Percentage “Thriving” and GDP per Capita (PPP) . . . . . 6

**LIST OF TABLES**

Table 1: Egypt - Selected Macroeconomic Indicators, 2000-2010. . . . . 4

Table 2: Egypt - Evolution of Inequality (%) . . . . . 5

Table 3: Egypt - Evolution of Poverty (%) . . . . . 5

Table 4: Egypt - Distribution of Population in Consumption Groups (%) . . . . . 8

Table 5: Egypt - Distribution of Population in Consumption Groups (Millions) . . . . . 9

Table 6: Head-Count Index at \$5/Day Poverty Line (%) . . . . . 9

Table 7: Number of Poor at \$5/Day Poverty Line (Millions) . . . . . 9

Table 8: Selected Governance Indicators, 2010 (Percentile Rank) . . . . . 11

Table 9: Comparing Youth Unemployment (Ages 15-24) (%) . . . . . 12

Table 10: Overview of MSE Sector in Egypt . . . . . 13

Table 11: Enterprises by Gender and Age of Entrepreneurs . . . . . 14

Table 12: The Distribution of MSEs according to Economic Activity . . . . . 15

Table 13: MSE Compliance with Official Procedures . . . . . 15

Table 14: Source of Initial Funding (% of Total) . . . . . 17

Table 15: Access to Infrastructure (% of Respondents Saying They Have No Access) . . . . . 18

Table 16: Constraints to Small Business (% of Entrepreneurs Saying it is a Major Constraint) . . . 18

Table 17: Credit to Small Businesses . . . . . 19

Table 18: Evolution of the Exchange Rate . . . . . 22



# THE ROLE OF MICRO AND SMALL ENTERPRISES IN EGYPT'S ECONOMIC TRANSITION

Hafez Ghanem

## INTRODUCTION

**T**he success of Egypt's transition to democracy will depend crucially on the ability of the democratically elected leadership to develop and implement a new economic vision that responds to the aspirations of the millions of youth who have so far been marginalized. Future growth needs to be much more inclusive than in the past. Therefore, encouraging youth entrepreneurship and the development of small businesses have to be central to any new growth strategy.

This paper focuses on the economic aspects of Egypt's transition. It argues that while past economic policies (especially starting in 2004) achieved high growth and poverty reduction, they failed to be inclusive as they left millions of Egyptians trapped in lower middle-class status living on \$2 to \$4 a day and provided few opportunities for youth who felt economi-

cally and socially excluded. There was an increasing sense that the system was "unfair," which explains the strong demands for social justice. Inclusive growth could be achieved by shifting away from a system of crony capitalism that favored large and established enterprises to one that focuses on developing small businesses and on creating more opportunities for young men and women.

The paper uses enterprise surveys from 2003, 2008, 2010 and 2011 to describe the Egyptian micro and small enterprise (MSE) sector and identify key obstacles to its development. It concludes by proposing a two-pronged strategy for the expansion and modernization of the MSE sector: a macroeconomic and regulatory environment that is conducive to the development of MSEs, and specific interventions to support the sector and encourage young entrepreneurs.

## **POLITICAL ECONOMY BACKGROUND: BUMPY TRANSITION AND DETERIORATING ECONOMY**

Supporting small businesses and young entrepreneurs makes political sense. Egypt's economic situation has declined sharply during the transition, and the young people who started the revolution may soon become disillusioned. There is a need to show that things have changed and that youths' dream for a more prosperous and just future is achievable. Resumption of growth is necessary, but if the benefits of growth continue to accrue to the lucky few, youth will be even more disillusioned. An economic program that focuses on developing small businesses and young entrepreneurs would demonstrate that things have really changed, and could be one way of reviving hope and mobilizing energies in support of the nascent democracy.

The Egyptian revolution of January 25, 2011 was started by youth calling for freedom, dignity and better living standards. The demonstrators in Tahrir Square shouted "bread, liberty and social justice." That is, the revolution had a political goal to build a more open and democratic society to achieve liberty, as well as an economic goal of high and inclusive growth to achieve bread and social justice. The two goals are linked. Transitions to democracy take time as they involve building new institutions and changing cultures. If they are not supported by a growing economy that creates opportunities and better living standards, they risk failure and a reversion to autocratic rule – or (even worse) the rise of extremist and xenophobic forces to power. At the same time, inclusive growth requires broad participation by all stakeholders in society, which is easier to achieve in open and more democratic systems.

Egypt's political transition has been bumpy, reflecting a power struggle between three groups: a military leadership that wielded tremendous power and appeared hesitant about the democratic transition, well-organized Islamist parties that are themselves divided between moderates who support democracy and hard-liners who want to establish a theocratic state, and liberal democrats who are disorganized and divided into a large number of small political parties – most of which have limited popular support. The final round of the presidential elections ended up being a contest between the two most powerful and best organized groups: the military and moderate Islamists. President Mohamed Morsi's election and his subsequent replacement of all the top military leadership marked a clear victory for the moderate Islamists and provided some hope for a successful democratic transition.

But the road ahead is long and with many obstacles on the way. There are still significant forces among the Islamists and the military that are not supportive of a Western-style democracy. The debate over the new constitution, and the accompanying civil unrest, demonstrated the extent to which the country is polarized between Islamists and liberals. The low participation rate at the December 2012 constitutional referendum, and the fact that the majority of people in Cairo (Egypt's capitol and by far largest city, as well as its commercial and cultural center) voted against it, indicate that the debate over Egypt's identity is probably not over. Compromises, which are made difficult by the lack of a democratic culture, still need to be reached in order to ensure future stability. Egypt's judiciary, press and political parties (all key institutions for a democracy) continue to be very weak.

During the period between February 2011 and December 2012, political issues and questions of na-

tional identity took center stage, and the economy was not a priority. The result has been quite negative. The young revolutionaries' demands for dignity and better jobs have yet to materialize. In fact the employment situation has worsened. Investment (both foreign and domestic) fell sharply, tourism came to a standstill and capital fled the country. GDP growth fell from more than 5 percent in 2010 to less than 2 percent in 2011, and as a result, officially measured unemployment rose from about 9 percent to more than 12 percent.

The country's financial situation deteriorated rapidly and ordinary Egyptians felt the pinch in terms of fuel shortages and electricity blackouts. The government deficit, which was already high before the revolution, ballooned to 10 percent of GDP in 2011 and nearly 12 percent in 2012. Accordingly, the public debt rose to nearly 80 percent of GDP, with a large increase in government borrowing from the domestic banking system. The government has been paying about 16 percent interest on its short-term treasury bills, sucking liquidity from the financial system and crowding out private investment. Meanwhile, foreign reserves, which stood at \$36 billion in 2010 (covering about seven months of imports), fell to \$15 billion in 2012 (slightly less than three months of imports). The situation would have been even worse if countries in the region (Qatar, Saudi Arabia, Turkey and Algeria) had not provided exceptional financial support.

A continued economic deterioration would probably have political repercussions and risks losing the few democratic gains achieved by the revolution so far. Stabilizing the macroeconomy is an obvious priority. Egypt had reached agreement on a program with the International Monetary Fund (IMF), but it had to be postponed as the unrest surrounding the adoption of the new constitution made it impossible for the government to implement much needed (but politically difficult) decisions on subsidies and tax increases. When an agreement with the IMF is finally approved, Egypt will have increased access to foreign financing from bilateral and multilateral donors. It could therefore start implementing a growth and job creation strategy to meet the aspirations of the youth who triggered the revolution.

The new economic program needs to be responsive to the revolution's demands for social justice. This would mean modernizing and expanding Egypt's social security and safety nets systems. It would also mean adopting a new, more inclusive growth model that ensures greater opportunities for youth. In the past, governments supported youth by expanding employment in the public sector, but this is no longer sustainable. New opportunities will need to be created by a growing and dynamic private sector, in which small businesses play a key role.

## PRE-REVOLUTION ECONOMIC DEVELOPMENTS: HIGH GROWTH AND HIGH DISCONTENT

During the 10-year period leading to the January 25, 2011 revolution, the Egyptian economy appeared to be doing well. A 2009 World Bank evaluation report states that “between fiscal 1999 and 2007 the Arab Republic of Egypt’s economic performance improved substantially. This was particularly true after 2004, following improvements in economic management, structural reforms, and correction of the exchange rate.” Table 1 seems to indicate that this positive evaluation of the country’s economic performance (one year before the start of the revolution) was warranted. GDP was growing at 5-7 percent a year (supported by high foreign and domestic investment) while the current account was under control and foreign reserves were high. Moreover, this strong performance continued even during the global financial crisis. In 2009

and 2010 the country was growing at a healthy 5 percent and had reserves equivalent to seven months of imports despite a decline in foreign direct investment and some deterioration in the current account balance. At 11-12 percent, inflation was high by international standards, but still within the Central Bank’s “comfort zone.”

Strong growth performance was achieved with what appeared to be virtually no change in income distribution (Table 2). The Gini coefficient remained stable at around 30-33 percent, which indicates a more equal distribution of income than many other developing countries. For example, Gini coefficients are about 55 percent for Brazil, 52 percent for Chile, 46 percent for Malaysia and 63 percent for South Africa. Table 2 also shows (as would be expected from a stable Gini coefficient) that the distribution of national income across quintiles has remained quite stable with the lowest

Year	Current Account Balance (% of GDP)	Foreign Direct Investment, Net Inflows (% of GDP)	GDP Growth (annual %)	GDP per Capita Growth (Annual %)	Gross Fixed Capital Formation (% of GDP)	Total Reserves in Months of Imports
2000	-1	1	5	3	19	7
2001	0	1	4	2	18	7
2002	1	1	2	0	18	8
2003	5	0	3	1	16	9
2004	5	2	4	2	16	7
2005	2	6	4	3	18	7
2006	2	9	7	5	19	7
2007	0	9	7	5	21	7
2008	-1	6	7	5	22	6
2009	-2	4	5	3	19	7
2010	-2	3	5	3	19	7

Source: World Development Indicators, World Bank.

Year	GINI Index	Income Share Held by Lowest 20%	Income Share Held by Second 20%	Income Share Held by Third 20%	Income Share Held by Fourth 20%	Income Share Held by Highest 20%
1990	32	9	12	16	21	41
1995	30	10	13	16	21	40
1999	33	9	12	16	21	42
2004	32	9	13	16	21	41
2008	31	9	13	16	21	40

Source: World Development Indicators, World Bank.

Year	Headcount Ratio at PPP \$1.25 a Day	Headcount Ratio at PPP \$2.50 a Day	Headcount Ratio at National Poverty Line	Population (Millions)
1990	4	44	---	58
1995	2	46	19	63
1999	2	37	17	68
2004	2	36	20	74
2008	2	32	22	78

Source: World Development Indicators, World Bank.

quintile receiving about 9 percent of income and the highest receiving about 40 percent. Doing the same calculations with deciles instead of quintiles does not change the result. The lowest deciles' share has been stable at around 4 percent and the highest deciles' share has been stable at around 27 percent.

Most poverty indicators also showed some improvement (Table 3). One dollar per day poverty was cut by half from 4 percent of the population in 1991 to 2 percent in 1996, but remained stable at that level until 2008. And, \$2 per day poverty was cut from 44 and 46 percent of the population in 1990 and 1995, to 36 and then 32 percent in 2004 and 2008. On the other hand, poverty rates using the national poverty line (a

little less than \$2 a day) increased from 17 percent in 2000 to 22 percent in 2008. With the benefit of hindsight, this should have raised concern. Nevertheless, most observers focused on strong growth, relative macroeconomic stability and declining poverty according to the standard \$2.50 in purchasing power parity (PPP) terms poverty line. The data seemed to indicate that Egypt was well on its way to becoming a development success story.

Good policies were credited for Egypt's economic performance. Economic reforms started in 1996 with some trade reforms, price liberalization and selected privatizations, and accelerated in 2004 when a new reformist government took office. The government

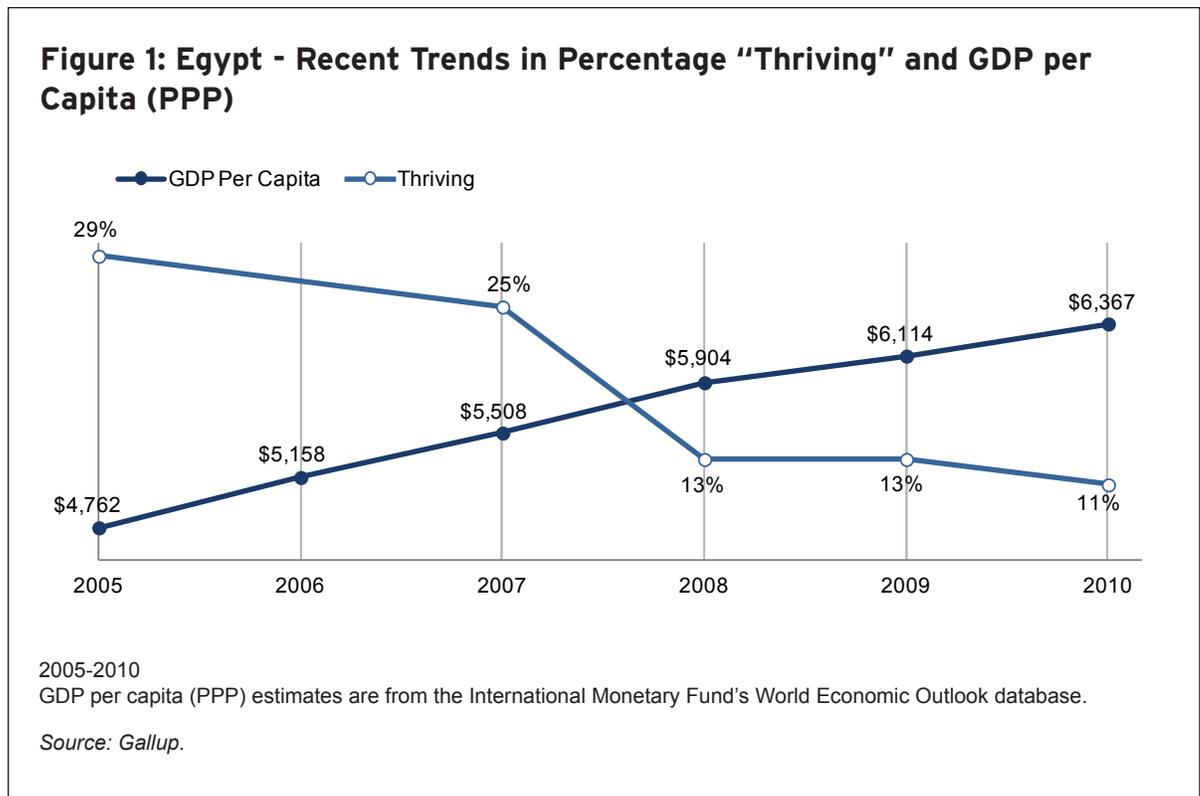
set out to further deepen the reforms by accelerating privatization, reducing tax rates and trade tariffs while simplifying the tax and trade regimes, and adopting more business-friendly policy and regulatory frameworks. This program was associated with a rapid increase in foreign direct investment (FDI) flows and a further acceleration of GDP growth, which led the IMF's 2010 staff report on the Article IV consultation with Egypt to state "the post-2004 reform agenda has started to pay dividends." Also in 2010 the World Bank identified Egypt as one of the top reformers in its "Doing Business Report," and the World Economic Forum moved Egypt up 11 places in its "Global Competitiveness Report."

Yet, Egyptians were bitterly complaining about inequality and poverty, and visitors commonly commented on the shocking difference between ostentatious wealth

in Cairo's gated communities and the squalor of its shanty towns. The graph below shows that the proportion of Egyptians who responded positively to a Gallup poll question of whether they are thriving fell from 29 percent in 2005 to 11 percent in 2010, even as per capita GDP increased by nearly 34 percent over the same time period. And, in January 2011 millions of Egyptians were demonstrating in the streets and a few weeks later Mr. Mubarak's regime fell.

What went wrong? The answer to this question could help the new Egyptian leadership define its economic program to avoid past mistakes and support inclusive growth and democratic development.

While highlighting aspects of good performance, many observers had mentioned signs of weaknesses in the Egyptian reform program under the Mubarak



regime, namely poverty and inequality, youth exclusion and corruption. The director general of the World Bank's Evaluation Department stated in his forward to the 2009 evaluation report that future World Bank work in Egypt should focus on "the persistent issue of poverty and inequality." The IMF's 2010 staff report on the Article IV consultation pointed out that "Transparency International cites accountability and transparency, and weakness in the legal/regulatory system as key reasons for Egypt remaining 111th of 180

countries in its Corruption Perception Index." While acknowledging that an Egyptian economic revival started in 2004 and had led to a marked improvement in the labor market, Assad and Barsoum (2007) state that "youth continues to be a most disadvantaged group in terms of higher rates of unemployment, lower earnings and limited job security and stability, with the majority of new entrants finding jobs within the informal economy." I shall examine those points in more detail in the next two sections.

## HOW DID THE 2004 REFORMS AFFECT THE MIDDLE CLASS?

A possible explanation for the rising discontent in Egypt is that the 2004 reforms increased the gulf between a struggling middle class and the elite. This could also explain why the revolution was led by educated youth who originate in the middle class. Such an explanation is consistent with recent literature, e.g., Diwan (2012), which emphasizes the important role that the Arab middle class plays in determining political regimes as well as work carried out by Homi Kharas at the Brookings Institution that stresses the importance of the middle class in economic development.

There are many ways of defining the Egyptian middle class. I start by following Banerjee and Duflo (2008) in defining the middle class as those living on more than \$2 a day but less than \$10 a day. Table 4 shows the distribution of the population among different consumption groups, and Table 5 shows the number of people in each of those groups. The two tables point out three important facts. First, according to this definition the Egyptian middle class is huge; it represents 83 percent of the population or 65 million people. Second, more than two-thirds of this middle

class (44 million people or 56 percent of the total population) live on less than \$4 a day. Popular culture in Egypt depicts the middle class as families where at least one member is a public employee. According to the Banerjee and Duflo definition this is apparently not true. The vast numbers of middle-class families who live on \$2 to \$4 a day work in small enterprises, mostly in the informal sector. Third, the reforms of 2004 do not appear to have helped the middle class. In spite of the increase in average income, the structure of the middle class remained basically unchanged between 2004 and 2008 with more than two-thirds in the \$2 to \$4 a day income group. It is also noteworthy that the number of people living on more than \$10 a day (and hence defined as upper class) has remained constant over those four years at about 1.9 million, and their proportion of the population declined slightly from 2.6 to 2.4 percent.

The above discussion could explain why the majority of Egyptians were discontent in spite of economic growth. Vast numbers were trapped in lower middle-class status, very close to the poverty line. They saw the small number of rich benefit from the economic reforms while they remained, for all intents and purposes, poor. This failure to raise the standards of liv-

Year	Less than \$2/day	\$2-\$4/day	\$4-\$6/day	\$6-\$8/day	\$8-\$10/day	\$10-\$12/day	\$12-\$14/day	More than \$14/day
2008	14.61	56.04	19.80	5.25	1.92	0.88	0.48	1.02
2004	17.56	54.44	18.30	5.17	1.97	0.93	0.51	1.12
1999	18.42	54.47	17.54	5.05	1.95	0.94	0.51	1.12
1995	25.21	54.40	13.53	3.62	1.38	0.67	0.37	0.82
1990	26.72	50.11	14.76	4.37	1.74	0.84	0.47	0.99

Source: Author calculations using The World Bank's PovCalNet tool.

Year	Less than \$2/day	\$2-\$4/day	\$4-\$6/day	\$6-\$8/day	\$8-\$10/day	\$10-\$12/day	\$12-\$14/day	More than \$14/day
2008	11.44	43.89	15.51	4.11	1.50	0.69	0.38	0.80
2004	12.79	39.65	13.33	3.77	1.43	0.68	0.37	0.82
1999	12.24	36.20	11.66	3.36	1.30	0.62	0.34	0.74
1995	15.65	33.76	8.40	2.25	0.86	0.42	0.23	0.51
1990	15.19	28.48	8.39	2.48	0.99	0.48	0.27	0.56

Source: Author calculations using The World Bank's PovCalNet tool.

Year	Brazil	Chile	China	Malaysia	South Africa	Egypt
1990	64	45	99	46	70	87
1995	51	36	96	45	72	89
1999	52	33	93	---	72	85
2004	47	24	80	48	66	85
2008	36	19	72	25	62	85

Source: World Development Indicators, World Bank.

Year	Brazil	Chile	China	Malaysia	South Africa	Egypt
1990	92	7	1,125	9	26	49
1995	84	5	1,172	9	28	55
1999	89	4	1,171	---	32	57
2004	91	5	1,044	12	31	62
2008	72	3	949	7	30	66

Source: World Development Indicators, World Bank.

ing for the lower middle class distinguishes Egypt's economic performance from that of successful developing countries. The World Bank publishes data on poverty using a \$5 poverty line. Tables 6 and 7 present the head-count index and the number of poor using this measure for Egypt and five comparator

countries. In Egypt the percentage of people living on less than \$5 a day has been stagnant at 85 percent between 2000 and 2008, and their absolute number increased from 57 to 66 million. During the same period Brazil, Chile, China, Malaysia and South Africa succeeded in reducing the proportion and ab-

solute number of people living on less than \$5 a day (although South Africa to a lesser extent than the others).

Does the above conclusion change if a different definition of the middle class is used? To respond to this question I use a definition developed by Homi Kharas at the Brookings Institution. According to this definition the middle class consists of “those households that have a certain amount of discretionary income that goes beyond the necessities of life to include consumer durables, quality education and health care, housing, vacations and other leisure pursuits. This group is differentiated from the poor in that they have choices over what they consume. They are differentiated from the rich in that their choices are constrained by their budget; they are price and quality sensitive.” According to this definition, middle class households are those that spend between \$10 and \$100 per person per day.

Applying the above definition to the World Bank’s household survey data, which is presented above, would yield a very small middle class in Egypt (roughly only 2 percent of the population). However, users of this definition typically apply it to the private con-

sumption data obtained from the national accounts that consistently yield a much higher figure for average consumption than the household surveys. Hence, I use the data for the global middle class that is available at the Brookings Institution. According to those estimates the Egyptian middle class has grown from 12 percent of the population in 2000 to 22 percent in 2010, which appears to be a positive development. However, this expansion was not sufficient to reduce the absolute number of people living below the middle-class level (hence poor according to this definition). This number increased from 60 million in 2000 to 63 million in 2010.

Therefore, it seems that the different data sets and definitions point out a similar conclusion. The number of people who are poor or lower-middle class continued to increase in spite of the economic reforms and the rapid growth. The vast majority of Egyptians did not benefit from the growth that occurred over the 10 years immediately preceding the revolution. Of course it is always possible to argue that given enough time growth would have “trickled down” and the poor would have ultimately benefitted. But this argument tends to ignore political realities.

## WEAK GOVERNANCE AND YOUTH EXCLUSION

Poor governance, high corruption and crony capitalism probably added to Egyptians' sense of unfairness. As shown in Table 8, Egypt ranked in the bottom half of all countries on corruption control in 2010. Among the five comparators, only China has a similar ranking. Egypt's record on corruption control is far below that of Chile, Brazil, Malaysia or South Africa. Corruption was (and probably still is) pervasive, ranging from small payments to traffic police to huge sums in return for access to government contracts.

Khatri et al. (2006) while analyzing East Asia argue that cronyism is a special type of corruption and that certain cultures are more prone to it than others. A system of crony capitalism is probably consistent with Egyptian culture where loyalty to friends and family is highly valued. In some sense it may also have been consistent with rapid (although noninclusive) growth. Richter and Steiner (2008) describe how this system worked in the tourism sector where the government sold land to private (mostly Egyptian) investors at \$1 per meter and then declared it Tourism Development Land, which made its value increase by 10,000 per-

cent. The private buyers were then able to use the land as collateral to get loans from banks that were thousands of times higher than their original investment. This system led to a rapid growth in tourism revenue, which rose by about 592 percent between 1991 and 2005, out-performing all other sectors of the economy. However, this growth mostly benefitted the well-connected elite (who appropriated the initial rent from the land purchase) and increased the sense of inequity. The majority of Egyptians who live on \$2 to \$4 a day were simply left behind.

Table 8 also shows that Egypt scored poorly on government effectiveness. The middle class (especially those who live on less than \$5 a day) are highly dependent on government services: health, education, transport and security. They suffered from the continual deterioration of those services. Children going to public schools need to pay their own teachers for private tuition in order to pass exams, and patients in government hospitals often need to pay bribes in order to get service. In 2010, a Cairo taxi driver described the relationship between Egyptians and their state as follows: "if a 'baltagy' (violent criminal) goes to a police station he is treated with respect because

	<b>Egypt</b>	<b>Brazil</b>	<b>Chile</b>	<b>China</b>	<b>Malaysia</b>	<b>South Africa</b>
Control of Corruption	34	60	91	33	61	61
Government Effectiveness	40	57	84	60	82	65
Rule of Law	52	55	88	45	65	58
Voice and Accountability	13	64	82	5	31	65

Source: *Worldwide Governance Indicators*.

they are afraid of him; if a rich man goes he will also be treated with respect but he must pay; but if a 'normal honest' citizen goes he is bullied and humiliated." This state of affairs could also explain why most Egyptians felt alienated despite the economic growth.

Young people, who represent about one-quarter of the population, felt particularly excluded. They did not participate in the social and political life of their country. Table 8 shows that Egypt scored far below all other comparators except China on voice and accountability. Assad and Barsoum (2007) describe the constraints faced by young men and women to express themselves and the controls placed on student activities by the security apparatus. The result was that most young people refrained from any civic activities or volunteer work. They felt that their voices could not be heard. Most activist youth joined Islamist movements who, according to Bayat (1998), provided them with an alternative moral and cultural community. Islamist organizations also provided youth with services, like libraries and sports facilities, that the public sector was unable to deliver.

Youth also suffered from economic exclusion, which can be best illustrated by examining labor market

outcomes. Table 9 shows that youth unemployment is higher in Egypt than in any of the comparator countries except South Africa. The Egyptian public sector has traditionally provided jobs to the large numbers of graduates entering the labor market each year; currently about 850,000 young people enter the labor market annually and 70 percent of them have completed at least secondary education. This changed with the economic reforms that aimed at controlling government spending and rationalizing the public sector. Given the high fiscal deficit and over-employment in the public sector, it is unlikely that this sector will be able to absorb many new graduates. As a result, it has become increasingly hard for young people to find jobs, and youth with secondary education or above represent about 95 percent of the unemployed in Egypt. The problem is particularly acute for young women who are 3.8 times more likely to be unemployed than young men. Of the young men and women who do find jobs, only 28 percent find formal sector jobs – 18 percent in the public sector and 10 percent in the formal private sector. The vast majority, 72 percent, end up working in the informal MSE sector, often as unpaid family workers. For those who are paid, many have no labor contract, no job security or social benefits.

<b>Table 9: Comparing Youth Unemployment (Ages 15-24) (%)</b>			
	<b>1998</b>	<b>2008</b>	<b>Share of Youth in Population</b>
Brazil	17	15	20.0
Chile	15	20	17.2
China	---	---	15.9
Malaysia	9	11	18.3
South Africa	45	47	20.5
Egypt	23	25	22.3

Source: World Development Indicators, World Bank and United Nations Population Statistics.

## THE EGYPTIAN MICRO AND SMALL ENTERPRISE (MSE) SECTOR

What is this small enterprise sector that provides jobs for nearly three-quarters of new entrants to the labor market and is a major source of livelihood for the poor and middle class? I shall use a simple enterprise classification system, widely accepted in Egypt, which is based on number of employees. According to this classification micro enterprises are defined as those employing less than 10 workers, small enterprises employ 10-49 workers, medium enterprises employ 50-99 workers, and large enterprises employ 100 workers and above. According to a CAPMAS 2006 Establishment Census (quoted in El-Mahdi (2012)), the Egyptian labor force is estimated at about 20.1 million workers, with about 7 million working for the public sector and the remainder divided nearly evenly between agriculture and the nonagriculture private sector. There are 2.5 million nonagricultural private enterprises in Egypt employing 7.3 million workers. Small and micro enterprises (with less than 50 workers each) represent nearly 99 percent of total private enterprises and about 80 percent of total employment (5.8 million workers). Furthermore, of those 5.8 million workers, 88 percent are employed by micro

enterprises, with 72 percent employed in enterprises with one to four workers and 16 percent in enterprises with five to nine workers. The remaining 18 percent are employed by small enterprises that employ 10-49 workers. This relative importance of small and micro enterprises for employment generation is not unique to Egypt. For example, Ozar et al (2008) and Samitowska (2011) show similar results for Turkey and Poland, respectively.

In view of their dominant position in the Egyptian labor market, this paper will focus on the micro and small enterprise sector. I shall be using two data sources: an MSE survey carried out by the Economic Research Forum (ERF) in 2003 covering 4,957 enterprises, and a survey of 3,000 enterprises carried out in 2010 and 2011, and reviewed by El-Mahdi (2012) in a background paper to the Brookings Institution. Whenever possible, I shall base my results on the more recent survey. However, the 2003 survey is larger and covers more questions.

The vast majority of MSEs in Egypt are very small with average assets valued at LE 30,000 (some \$5,000) and average employment of 2.2 workers (see Table 10). The average age of the owner/manager of an en-

	<b>Average Assets (LE)</b>	<b>Average Employment (No. of Workers)</b>	<b>Education Entrepreneur (Years of Formal Education)</b>
Total	30,147	2.2	8.4
Youth (ages 15-24) Entrepreneur	16,809	2.3	10.3
Youth & Female Entrepreneur	18,368	2.4	11.2

Source: Author's calculations from the ERF 2003 survey.

terprise is 40.3 years, with an average education level of 8.4 years of formal schooling. Woman entrepreneurs head about 10.5 percent of enterprises. About 12 percent of entrepreneurs are young, between ages 15 and 24. Enterprises headed by youth tend to have fewer assets (nearly half as much) than the average. Another important feature of young entrepreneurs is that they tend to be better educated than older colleagues, with an average education of 10.3 years. In fact the simple correlation coefficient between age and years of education for the whole sample is

-0.33. Some 15.4 percent of young entrepreneurs are women. They tend to be better educated than their male counterparts, and their enterprises tend to be slightly bigger. Table 11 shows the age structure of entrepreneurs from the 2011 survey. Youth, defined as younger than 25 years old, represent only 10 percent of the sample (slightly less than in the 2003 survey). However, Table 11 also shows that if we extend the definition of youth to include all of those younger than 30 years old, then young entrepreneurs would represent about 23 percent of total entrepreneurs.

<b>Age</b>	<b>Male</b>	<b>Female</b>	<b>Total</b>
<18 years	0.2%	0.8%	0.2%
18 to <21 years	2.0%	4.1%	2.2%
21 to <25 years	7.4%	9.6%	7.6%
25 to <30 years	12.9%	13.0%	12.9%
30 to <40 years	27.2%	21.2%	26.6%
40 years or more	50.4%	51.3%	50.5%
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

Source: El-Mahdi, 2012.

Young people's share of employment in MSEs is much higher than their share in ownership. Using data from the 2003 ERF survey I estimate that those in the 15-24 age group represent 37 percent of total MSE employment. If we define youth as being younger than 30 years old then this share rises to more than 50 percent. Women's employment in MSEs remains low at only 11.4 percent as those enterprises are not considered "safe" for female workers. Half of the women working in MSEs (50.1 percent in the ERF 2003 sample) are younger than 25 years old. Wages are low, and the average wage for male workers in the 2011 survey is \$3.70 a day and that for female workers is \$2.60 a day. Slightly more than half (50.5 percent in

the 2003 ERF survey) of employees have a work contract, which shows the precarious nature of employment in this sector.

Egyptian MSEs are mostly family businesses providing simple services to the household sector. Data from the 2003 ERF survey indicates that 63.5 percent of MSE employees are related to the owner/manager, which supports the view of this sector being dominated by family businesses. As shown in Table 12 some 60 percent of MSEs work in trade. These are small retailers and wholesalers who sell food products, clothes, furniture, plastics and building materials. About 30 percent operate in the services sector

<b>Table 12: The Distribution of MSEs according to Economic Activity</b>			
	<b>Frequency</b>	<b>Percent</b>	<b>Valid Percent</b>
Trade	1,806	60.2	60.2
Services and Maintenance	886	29.5	29.5
Manufacturing	308	10.3	10.3
Total	3,000	100.0	100.0

Source: *El-Mahdi, 2012.*

including transportation and distribution, laundry, cafes, restaurants and hotels. Only 10 percent of enterprises are in manufacturing, including food processing, wood and furniture, ceramics, building materials, and some electrical and engineering workshops. In response to a question about their main clients, 90 percent of enterprises mention households, 8 percent sell to other firms or home-based workers, and 2 percent sell to government or public enterprises. Thus it is evident that very little subcontracting is taking place. More than 99 percent of MSEs sell mainly to local markets with very few selling in the national market (within Egypt). Only 0.3 percent of enterprises sell to the export market.

Peattie (1987) stated that the concept of an informal sector is "utterly fuzzy," and this seems to be the case in Egypt where most MSEs operate in a grey zone between formality and informality. In order to be considered formal an Egyptian enterprise needs to have

a business license, be registered as a commercial or industrial establishment, obtain a tax card and keep regular accounts. Noncompliance with one or more of those four official procedures would make the enterprise count as informal. Table 13 shows the status of compliance in the 2011 sample. Only 21.6 percent of enterprises comply with all four procedures and are therefore considered as formal. On the other extreme, 18.4 percent do not comply with any procedure and therefore operate completely informally. The remaining 60 percent of enterprises comply with one or more (45 percent of the total comply with 3 out of 4) of the procedures and are officially considered informal, but in fact seem to be at least partially formal. The one procedure that is least complied with is (unsurprisingly) that of maintaining regular accounts and presenting them to the tax department (see Table 13). The degree of formality is positively correlated with the size of the enterprise and the education level of its owner; and urban-based enterprises tend to be

<b>Table 13: MSE Compliance with Official Procedures</b>	
	<b>Percentage of MSEs</b>
Business License	66.4
Commercial/Industrial Registration	70.1
Tax Card	73.1
Keeping Regular Accounts	28.4

Source: *El-Mahdi, 2012.*

more formal than rural-based ones. Similar results on the relationship between formality and firm size, and the characteristic of the entrepreneur were found by Jackle and Li (2006) for Peru.

MSEs have very low capital-labor ratios and tend to use simple traditional technologies. The average capital-labor ratio calculated from the 2003 survey is around LE 10,000 (about \$1,600) and LE 14,000 (about \$2300) from the 2011 survey. The surveys asked entrepreneurs about the type of technology they use, including the choice between traditional, modern and up to date. Among the manufacturing enterprises 68 percent stated that they use traditional technology, while 30 percent use modern technology, and only

2 percent use up-to-date technology. In services the shares were 71 percent traditional, 27 percent modern and 2 percent up to date; while the shares in the trade sector were 80 percent, 19 percent and 1 percent respectively. On the other hand, 30 percent of entrepreneurs stated that they introduced innovations to their services and products to meet changing market needs. A 2008 survey on innovation covered 3,000 manufacturing and services enterprises. It found that 19 percent of enterprises had technological innovation activities, with manufacturing firms and larger firms being more likely to innovate. About 90 percent of innovations were produced within the firm and only 10 percent were produced in collaboration with domestic or foreign partners.

## CONSTRAINTS FACING MSEs

When asked why they did not use modern technology, more than half of the entrepreneurs stated that they could not afford the expense. Table 14 shows sources of funding for MSE startups. It indicates that only 2.3 percent of entrepreneurs were able to get a formal loan in order to start their business, and 2.9 percent obtained an informal loan. Access to financing at start-up is even more difficult for youth, as only 1.4

percent of them were able to get a formal loan and 2.2 percent obtained an informal loan. Most entrepreneurs (68.6 percent of total and 73.7 percent of youth) relied on their own savings to start their business. Inheritance is also an important source of financing, with 20.2 percent of entrepreneurs (18.7 percent of youth) stating that they used money that they inherited to start their business.

	<b>All Entrepreneurs</b>	<b>Youth Entrepreneurs</b>
Formal Loan	2.3	1.4
Informal Loan	2.9	2.2
individual Savings	68.6	73.7
Inheritance	20.2	18.7
Others	6.0	4.0

*Source: Author's calculations from the 2003 ERF survey.*

Access to infrastructure and public services is an important factor affecting the performance of all enterprises, but particularly small ones who do not have the resources to invest in alternatives to publicly provided infrastructure. Table 15 presents the proportion of entrepreneurs who answered "no" in response to questions about access to different types of infrastructure. A surprising finding here is the high proportion that does not have access to land line telephones (71.9 percent of the total population and 73 percent of youth). However, it is not clear how serious this is at a time of increasing access to mobile phones. Public transport for people and goods appears as a major problem for MSEs, with some 95 percent of them stating that they do not have access to those services. The same is true for water and sewage, as 59.4 percent of respondents stated that they had no access to water and 68.1 percent have no access to sewage. There does not

appear to be a significant difference between young entrepreneurs and the rest of the sample in terms of access to infrastructure and public services.

Two-thirds of small entrepreneurs identified taxation (tax rates as well as tax administration) as a key constraint facing their business development (Table 16). This is consistent with the earlier finding that the vast majority of small firms did not comply with the requirement to file their accounts with the tax department. It is commonplace for businessmen all over the world to complain about taxes. Nevertheless, the loud complaints (based on 2003 data) and massive non-compliance (based on 2011 data) may be an indication that a review of tax policies affecting small businesses is warranted. About 61 percent (64 percent of youth) entrepreneurs mentioned licensing and registration as key constraints. This is surprising since in the 2003

<b>Table 15: Access to Infrastructure (% of Respondents Saying They Have No Access)</b>		
	<b>All Entrepreneurs</b>	<b>Young Entrepreneurs</b>
Water	59.4	57.2
Electricity	6.7	5.7
Telephone	71.9	73.0
Sewage	68.1	67.2
Roads	10.8	9.9
Transport of Workers	96.6	97.1
Transport of Goods	94.8	95.4

Source: Author's calculations from the 2003 ERF survey.

survey about 70 percent of respondents report having complied with those requirements. During 2004-2010 the government, as part of its economic reform program, embarked on a massive deregulation and simplification effort. Hence, this conclusion could be due to data from an earlier period. However, El-Mahdi (2012) states that the deregulation and simplification effort does not seem to have affected the MSE sector, based on a 2011 survey. Hence, there may be two explanations for this result: The entrepreneurs may be ill-informed and unaware of the changes, or the deregulation and simplification measures are not being applied by a bureaucracy that is keen to protect possible sources of rents.

Table 16 also shows that financing is seen as a major constraint by nearly 65 percent of entrepreneurs (61 percent of youth). More detailed data on access to credit is presented in Table 17, which shows that only 5 percent of entrepreneurs said that they have had any access to credit and of those, 47.9 percent (57.1 percent of youth) received that credit from family, friends or business associates. Banks provided 35.6 percent of credit to MSEs while the Social Fund for Development and NGOs provided 9.2 and 7.3 percent, respectively. The table also shows that young entrepreneurs have much less access to credit from banks and the Social Fund for Development than older ones.

<b>Table 16: Constraints to Small Business (% of Entrepreneurs Saying it is a Major Constraint)</b>		
	<b>All Entrepreneurs</b>	<b>Young Entrepreneurs</b>
Securing Capital	64.6	62.1
Licensing & Registration	61.3	64.0
Labor Law	32.3	35.7
Labor Inspection	44.9	49.2
Tax Rates	68.6	66.7
Customs Duties	5.8	5.8
Tax Administration	65.0	63.0

Source: Author's calculations from the 2003 ERF survey.

The surveys indicate a significant level of dissatisfaction with government policies affecting small businesses. Entrepreneurs claim that the regulatory framework (licensing, registration, etc.) is a hindrance, that it costs significant time and money, that taxation is high and cumbersome, and that they have little ac-

cess to basic infrastructure and to credit. Very few seem to have benefitted from targeted interventions such as credit from the social fund or special training programs. Hence, there seems to be a good case for a review of policies and programs affecting small enterprises in Egypt.

<b>Table 17: Credit to Small Businesses</b>		
	<b>All Entrepreneurs</b>	<b>Young Entrepreneurs</b>
Percent with Access to Credit	5.3	4.8
Of Which: Friends & Family	47.9	57.1
Bank	35.6	28.6
Social Development Fund	9.2	3.6
NGO	7.3	10.7

*Source: Author's calculations from the 2003 ERF survey.*

## POLICY IMPLICATIONS

It is important for Egyptian policymakers and international donors to recognize that past noninclusive growth patterns, together with a system of crony capitalism, can at least partly explain popular dissatisfaction with the Mubarak regime and the ensuing revolution. Many observers still claim that the revolution was about political rather than economic rights. This would imply that the new government just needs to continue implementing past economic policies and return to past growth patterns. The democratic reforms would ensure increased transparency, participation and accountability – and hence decreased corruption. This argument is appealing, but is not consistent with the political economy analysis presented here. Democracy, transparency, participation and accountability are certainly key popular demands, and are also necessary to achieving inclusive and sustainable growth. But they are not enough. The youth who started the revolution are asking for a change in their economic situation, and they are probably not willing to wait until the benefits of growth “trickle down” to reach them.

Government needs to develop a new growth strategy – in which small business and youth entrepreneurship play a key role – that responds to the revolution’s demand for bread and social justice. Donors also need to adjust their portfolios to reflect the new political realities. Failure to do so could lead to more disillusionment and cynicism, and could ultimately jeopardize the transition to democracy.

The objective of government policy and donor interventions should not be simply to support the growth of the existing MSE sector. It should also aim to transform it by raising its productivity and its linkages to domestic and international markets. Finding low paying jobs in MSEs for the 850,000 young people who enter the labor market each year so that they

increase the ranks of those living on \$2 to \$4 a day will not solve Egypt’s social problems. The objective should be to support the modernization of the sector so that it can become more dynamic, providing better living standards for young entrepreneurs and decent jobs for new entrants to the labor market. A possible vision for the Egyptian MSE sector would be to become similar to the sectors in Europe or Japan where MSEs lead in innovation, often operate in clusters and have strong links to larger firms as well as to national and international markets. The key short-term challenge is to create more opportunities for youth who currently suffer from social and economic exclusion. Young women who are discouraged and drop out of the labor market pose a special problem, because increasingly families need two earners in order to ensure a decent living for parents and children.

Government cannot provide all of the solutions on its own. Past government interventions to support the MSE sector in Egypt and elsewhere have often proven to be ineffective (e.g., deregulation and simplification after 2004 does not appear to have encouraged more enterprises to become formal) and even harmful at times (e.g., Hill (2001) describes how some of the subsidized credit schemes in Indonesia hurt rather than helped the sector by limiting access). It is important that a new MSE development strategy be devised based on a broad consultation with owners and workers as well as with students who will soon be looking for jobs. Large firms could also contribute to the debate with the aim of increasing interfirm linkages and subcontracting. This would be an excellent opportunity to demonstrate the benefits from Egypt’s new, open and democratic political system. For decades Egypt’s youth have felt that their voice was not being heard, which left them cynical and disheartened. Now could be the right time to engage youth in a broad national debate about their future and their country’s development path.

NGOs play a significant role in supporting MSEs. They provide about 10 percent of all credit to the sector, from their own resources as well as working as delivery agents for the Social Fund for Development. They also are in a good position to provide technical and marketing support, and to help organize broad consultations with relevant stakeholders. Government can help develop NGOs by passing a new law regulating their activities and simplifying procedures for their registration and operations (see Kharas and Abdou (2012)). The NGO sector could also provide opportunities for young men and women interested in engaging in the civic lives of their communities and participating in social development and the fight against poverty.

Egypt could benefit from the experience of other countries in MSE development. For example, Hill (2001) reviewed two successful MSE experiences from Indonesia: the Bali garment industry and the Jepara furniture manufacturing cluster. He concluded that four factors were crucial for their success: (1) the existence of some basic industrial competence in a specific field; (2) a conducive macroeconomic environment, including a competitive exchange rate; (3) reasonably good physical infrastructure; and (4) the injection of technical design and marketing expertise that link small producers to new ideas and major markets.

The surveys of Egyptian MSEs discussed in this paper demonstrate that there is basic competence in several fields like tourism and the hospitality industry, textiles, food processing, ceramics, furniture, and more recently information and communication technology. The surveys also show that physical infrastructure, especially roads and electricity, do not appear to be the main constraint for MSE development. Hence, it seems that (at least in the short run) the Egyptian government, with support from its international part-

ners, needs to focus on providing a conducive macroeconomic environment and on developing a few targeted programs to encourage small enterprises and young entrepreneurs obtain business and technical expertise, as well as better linkages to markets.

## **Conducive Macroeconomic Environment**

A conducive macroeconomic environment for small business implies a stable economy, a competitive exchange rate, policy and regulatory frameworks that encourage MSEs, and efficient noncorrupt institutions.

Egypt's agreement with the IMF to support its stabilization program is an important step that needs to be finalized as soon as possible. An agreement with the IMF will provide Egypt with access to an increased level of external financing from the IMF itself, as well as from other donors who link their assistance to a credible macro-framework. It would also provide an encouraging signal to foreign and domestic investors, and help restore confidence in the Egyptian economy. Therefore, it is important for small businesses. However, stabilizing the economy also involves taking politically difficult decisions especially on fuel subsidies, which consume 6-7 percent of GDP, and the taxation of some consumer goods. It needs to be accompanied by strong public information campaigns and measures to protect the most vulnerable (Vagliasidi, 2012). Indonesia was able to reduce fuel subsidies in 2006 after it launched a public information campaign that clearly identified the benefits of the reform and the compensatory social measures that will accompany it. Similarly, Ghana launched a study on fuel subsidies in 2004. The study's steering committee included a large number of stakeholders (government officials, academics, company representatives, etc.). In 2005 the government used the study

to launch a public information campaign that included a description of the social mitigation measures and was able to peacefully increase fuel prices by 50 percent.

A competitive real exchange rate encourages the development of MSEs. In that sense the depreciation of the Egyptian pound that accelerated in December 2011 is welcome, but probably still not sufficient. Table 18 presents the evolution, from 2004 to the second quarter of 2012, of Egypt's consumer price index (CPI), the U.S.'s CPI, the Egyptian pound (LE)/\$ exchange rate, the nominal exchange rate expressed as an index, and an index of the real exchange rate that is defined here as the nominal LE/\$ exchange rate index adjusted for the differential CPI inflation between the two countries. There are many other definitions of the real exchange rate, but I stick here to this definition because it provides the simplest way of demonstrating the point that Egypt's real exchange rate has been appreciating over the whole period and continued

appreciating even after the revolution. Using other definitions does not change the result. Inflation was much higher in Egypt than in the U.S. over the period 2004-2010 (just before the revolution), the Egyptian CPI increased by 81.2 percent while the U.S. CPI increased by only 15.5 percent over those six years. The Egyptian pound also appreciated, moving from LE 6.2/\$ in 2004 to LE 5.6/\$ in 2010. As a result, the real exchange rate appreciated by about 42 percent. The Egyptian pound depreciated after the revolution from LE 5.6/\$ in 2010 to LE 6.0/\$ in the second quarter of 2012. However, this depreciation was not enough to offset the inflation differential between the two countries and the real exchange rate appreciated by an additional 3.7 percent. In its 2010 report on the Article IV consultation with Egypt, the IMF states "the real effective exchange rate appreciated by over 25 percent since the benchmark period for the last exchange rate assessment (end-2007) and now appears somewhat overvalued under each of the standard metrics." If the real exchange rate was somewhat

Table 18: Evolution of the Exchange Rate									
	2004	2005	2006	2007	2008	2009	2010	2011	2012-Q2
Egypt CPI	95.4	100	107.6	117.7	139.2	156.6	173.1	190.5	203.2
U.S. CPI	96.7	100	103.2	106.2	110.2	109.9	111.7	115.2	117.7
LE/\$ Exchange Rate	6.2	5.8	5.7	5.6	5.4	5.5	5.6	5.9	6.0
Nominal Exchange Rate Index	107.2	100	99.2	97.5	94.0	95.9	97.3	102.7	104.3
Real Exchange Rate Index	108.8	100	95.1	88.0	74.7	67.7	62.7	62.1	60.4

Source: International Financial Statistics, IMF and author's calculations.

overvalued when growth was strong and the country had external reserves covering seven months of imports, it is probably safe to assume that today it is grossly overvalued.

A review of the policy and regulatory frameworks affecting MSEs is needed. There is a high level of non-compliance with tax laws and regulations, which raises the question of whether they should be revised and simplified to encourage more enterprises to become formal. The government may wish to consider providing tax incentives for small businesses and for young entrepreneurs. Businesses continue to complain about the regulatory framework in spite of the recent simplification. It may be necessary to take another look at the processes affecting small enterprises, in consultation with entrepreneurs. Government should also consider policies to encourage foreign investors to partner with Egyptian MSEs to help them obtain technical design and marketing expertise. In the case of the garment industry in Bali, the Indonesian government reduced the minimum level of foreign investment from \$1 million to \$250,000 in order to encourage small foreign investors to partner with local MSEs, bringing in their technical know-how and market access.

Good tax laws and simple regulations will only be effective if their implementation is not marred by abuse and corruption. Hence, efforts to fight corruption and to professionalize the civil service could have a positive impact on MSE development. Fighting corruption is an important goal of the revolution, and since February 2011 there have been more than 6,000 corruption investigations and several high profile incriminations (AfDB et al. 2012)). While this may send a signal that corruption will not be tolerated, it is not an effective way of ending the type of corruption that hampers the work of MSEs. Government needs to

partner with civil society, the press and business owners to bring about greater transparency and hold civil servants accountable. During its transition, Indonesia created the Partnership for Governance Reform between government and civil society to lead the fight against corruption.

### **Targeted Interventions to Support MSEs and Young Entrepreneurs**

Direct interventions by government and donors to support MSEs could include strengthening the Social Fund for Development, support to some pilot MSE clusters and programs for entrepreneurship development.

The government has designated the Social Fund for Development as the apex institution for the expansion and development of the MSE sector. However, the Social Fund for Development also has another mission, which is to develop safety nets and labor intensive public works programs. Both missions are important, but they are quite different. There is a risk of their getting confused. For example, the Social Fund for Development could be supporting some MSEs that have a little chance for development as part of its social protection function. It seems, therefore, that there is a need to sharply separate the two roles either by breaking up the fund into two institutions (which may imply a loss of some economies of scale) or by organizational changes within the Social Fund for Development to ensure separate accountabilities.

Developing small businesses is a long-term objective that should be protected as much as possible from shifts in short-term political priorities. An independent review of the fund carried out in 2011 recommended ensuring its independence from political intervention. It is important to implement those

recommendations and to strengthen the governance of the Social Fund for Development in a way that ensures that small entrepreneurs, especially youth and women, have a voice in its operations and strategies.

Strengthening capacity of fund staff is also a priority, with two areas where it is particularly needed. First, the Fund needs to have the capacity to analyze policies affecting MSEs and propose action. Fund staff should play an important advocacy role, ensuring that the interests of MSEs are taken into account in policy deliberations. They are well placed to play this role since all of the important economic ministers are members of the Social Fund for Development's board of directors. Second, priority should be given to strengthening the fund's business development and nonfinancial services. Like most social funds around the world, the fund's focus has been on providing financing, usually through NGOs or commercial banks. But financing alone cannot transform Egypt's MSE sector. There is a need for business training, technology transfer and access to markets. Naturally, the Social Fund for Development itself should not directly provide those services, but rather work with private providers. However, very few staff are equipped for this type of activity.

The Social Fund for Development is considering some pilot projects to develop MSE clusters. It is looking at possible clusters for furniture manufacturing in Damietta and in upper Egypt, as well as at a petrochemicals cluster in Suez. Cluster development could be a very useful activity, provided that it is based on an existing local competence. Initially, the fund could focus on supporting local MSEs to better connect with each other, modernize, and link to national and international markets. For such an endeavor to succeed, it would be important to partner with a private enterprise that can provide the technical support and

market access. Bringing in a foreign partner would be particularly useful for export-oriented activities. Mobilizing donor support for those types of projects should not be difficult.

A key challenge to the implementation of the vision presented in this paper is that young Egyptians are not prepared for a life of entrepreneurship and risk taking. Egypt has an antiquated education system that has been geared to produce civil servants and does not provide graduates with the skills needed to survive in a 21st century market place. Educated youth in Egypt do not have the skills or the inclination to start their own business. They prefer the security of a public sector job even if it implies a long period of unemployment as they wait for a job opening. The obvious solution to this problem is to reform and modernize the education system. This is clearly an important developmental priority, but it will take time to implement and will not affect the millions of youth who are currently in the labor market. The Social Fund for Development could develop entrepreneurship programs to provide skills to youth and help them start their own business. It has a track record of projects and programs that target women entrepreneurs that could be further expanded, and new programs that specifically target youth and new graduates could be developed.

The above are some policy directions and possible priorities for intervention, that may warrant further exploration by government and its development partners. A successful modernization and expansion of Egypt's MSE sector would be an important component of an economic program that aims at achieving inclusive growth. A comprehensive strategy for the sector, taking into account the new political and social realities, needs to be developed through a consultative process that includes all stakeholders.

## BIBLIOGRAPHY

- Abu Elmagd, M., El Oraby, N., Pillay, R. (2011) "Social Fund for Development: An Independent, Forward Looking Review", *Social Fund for Development*, Cairo.
- AfDB et al. (2012) "Egypt" in *African Economic Outlook 2012: Promoting Youth Employment*, OECD Publishing.
- Assad, R., Barsoum G. (2007) "Youth Exclusion in Egypt: in Search of Second Chances," *Wolfensohn Center for Development*, Washington DC.
- Banerjee, A. and Duflo E. (2008) "What is Middle Class about the Middle Class around the World?" *Journal of Economic Perspectives* (22) 2.
- Bayat, A. "Revolution without Movement, Movement without Revolution: Comparing Islamic Activism in Iran and Egypt" *Studies in Society and History* (40) 1.
- Diwan, I. "Understanding Revolution in the Middle East: The Central Role of the Middle Class" *Economic Research Forum Working Paper No. 726*.
- El-Mahdi, A. (2012) "Improving Opportunities of the Micro and Small Enterprises in Egypt" processed The Brookings Institution.
- Hill, H. (2001) "Small and Medium Enterprises in Indonesia: Old Policy Challenges for a New Administration," *Asian Survey* (41) 2.
- International Monetary Fund (2010) "Arab Republic of Egypt Article IV Consultation-Staff Report," Washington DC.
- Jackle, A. and Lee, C. (2006) "Firm Dynamics and Institutional Participation: A case Study of the Informality of Micro Enterprises in Peru", *Economic Development and Cultural Change* (54) 4.
- Kharas, H. and Abdou, E. (2012) "Regulatory Reforms Necessary for an Inclusive Growth Model in Egypt," *Global Views*, The Brookings Institution.
- Khatri, N., Tsang E., Begley T. (2006) "Cronyism: a Cross Cultural Analysis" *Journal of International Business Studies* 37, 61-75.
- Ozar, S., Ozartan, G. and Irfanoglu, Z. (2008) "Micro and Small Enterprise Growth in Turkey: Under the Shadow of Financial Crisis," *The Developing Economies* XLVI (December).
- Peattie, Lisa (1987) "An Idea in Good Currency and How it Grew: The Informal Sector", *World Development* 15 (July).
- Richter T., Steiner C. (2008) "Politics, Economics and Tourism Development in Egypt: Insights into the Sectoral Transformations of a Neo-Patrimonial, Rentier State" *Third World Quarterly* (29) 5.
- Samitowska, W. (2011) "Barriers to the Development of Entrepreneurship Demonstrated by Micro, Small and Medium Enterprises in Poland," *Economics and Sociology* (4) 2.
- Vagliasidi, M. (2012) "Implementing Energy Subsidy Reforms: an Overview of Key Policy Issues" *Policy Research Working Paper 6122*, The World Bank. Washington DC.
- The World Bank (2009) "Egypt: Positive Results from Knowledge Sharing and Limited Lending, an IEG Country Assistance Evaluation" Washington DC.





The views expressed in this working paper do not necessarily reflect the official position of Brookings, its board or the advisory council members.

© 2013 The Brookings Institution

ISSN: 1939-9383

# BROOKINGS

1775 Massachusetts Avenue, NW  
Washington, DC 20036  
202-797-6000  
[www.brookings.edu/global](http://www.brookings.edu/global)

