Putting Egypt on the Right Track

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Part Two

LAST week I discussed the areas in which public-sector reform in Egypt is a must. In this article, I will continue to outline those areas where reform is fundamentally important if the country is to seriously attempt to put the public sector on the right track.

• Privatization and employee stock ownership plans (Esops): On the privatization frontier the Ministry of Industry has already taken a serious step forward by agreeing to implement the first-ever Esop in the industrial sector, at Trenco-Alexandria Tire Company. Real reform, though, implies the development of more Esops in public industries with the objective of minimizing the burden on the government from faltering state-owned enterprises.

Of course, Esops are only applicable in those enterprises where no serious debt burden has accumulated over the years. Esops may also be considered for those new public enterprises which the state is currently establishing as a formula for linking wages to productivity and avoiding the mistakes of the past.

• Regulations on output mix: The government still intervenes directly in determining the output level and composition of state firms. One type of intervention is to set output targets; another is to fix output quotas. Affected enterprises are required to produce at least the quota defined. Finally, in some instances, a restriction is imposed on the export of a product considered essential for domestic consumption. Output targets and quota levels are established during the annual meetings of a state enterprise's general assembly. Export restrictions are imposed mainly in response to developments in the domestic market.

The problem in setting quantity targets for state enterprises is that they become an end in themselves. By linking management incentives to the fulfilment of quantity targets, enterprises are induced to pursue this objective without regard to cost effectiveness. Similarly, by requiring enterprises to produce a fixed quantity of certain commodities without considering profitability, resources are misallocated.

• Removal of constraints on management operations: In addition, the area of management role is important, but it is not the sole reform that needs to be undertaken in state enterprises. Depressed salary scales in the public sector have attracted a very low caliber of management professionals who are working in a system in which autonomy and accountability are seldom linked. Contracting

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A Point Of View

out management is a viable alternative when the privatization of an asset is conceivably difficult. The Ministry of Tourism has been quite successful in this regard.

• Financial management policies: These primarily affect the finances of state enterprises, and they also determine enterprise productivity by affecting managerial flexibility and accountability. Financial policies may be broadly classified under two categories: policies relating to the financial capital structure of enterprises and policies concerning the distribution of state enterprise surpluses.

Financial capital structure involves two main aspects: the issue of 'debt-versus-equity' participation by the government and availability of bank credit for working capital. The debt-equity ratio, a major determinant of creditworthiness for private enterprises, is often considered irrelevant for public enterprises because in most instances the government is the chief source of finance.

Nevertheless, the distinction between debt and equity is relevant for the financial autonomy of public enterprises and in order to ensure the firms' accountability. A public enterprise that finances the bulk of its needs through retained earnings is likely to be more autonomous in financial matters and, therefore, plans its operations better than an enterprise that is more dependent on the government for financial resources.

Although the solvent enterprises would normally prefer to be independent from the government, the financially weak enterprises would favor larger equity participation because it is considered a free resource in the sense that it does not impinge on the cash flow position.

A large equity participation by the government might weaken the financial discipline of a state enterprise and permit low or negative profits to be sustained. Another problem is that it would constrain the recycling of government funds, which are generally limited. Concerning the distribution of public enterprise surpluses, it is common for the governments of developing countries to make special arrangements for these to be used to finance their budgets.

A key issue is the appropriate policy for the distribution of surplus. A rigid rule requiring a transfer of the bulk of the surplus can create significant inefficiency problems by constraining the flexibility of enterprises to plan their growth strategy.

Egypt's state enterprises have faced a variety of financial controls and limitations with regard to their financial management policies and the distribution of their surpluses. One can safely say that if the government is serious about public-sector reform it must seriously consider not only management recruitment but also the endorsement of privatization and liquidation reforms along with the removal of a host of financial management controls.