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POLICY BRIEFS

Policy Brief on Egypt's IMF and World Bank Loan Programs

The dilemmas of the budget consolidation target

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Introduction

Egypt signed an agreement with the World Bank to obtain a $3 billion Development Policy Loan in the final days of 2015. Egypt shall receive the amount over three annual installments (two have already been disbursed). Few months later, Egypt embarked on negotiations with the International Monetary Fund (IMF) for the largest external loan in its history and one of the largest loans granted by the IMF in its history. The loan is worth $ 12 billion, disbursed to Egypt over semi-annual installments over a period of three years, the period of implementation of the signed program.

Both loans have been extended in a period characterized by increased reliance on external borrowing. A period in which Egypt is suffering from a balance of payments deficit and the erosion of international reserves as a result of the free flow of frightened capital during a period of great political instability. This leads to questioning the proper timing of reliance on foreign loans.

External borrowing during the past 6 years was done without any accountability or popular debate, in light of total absence of the role of parliament, especially as a large part of external borrowing was made by the Central Bank, without coordination with the government. This raises the question of the legitimacy of such borrowing.

Indeed, the IMF and World Bank loans are tainted with the suspicion of unconstitutionality. The Government signed agreements with the two institutions and began to implement the procedures and disbursement of payments without the Parliament's approval.

This was an indispensable introduction to the status of IMF and World Bank loans in their broader frameworks, namely the increased dependence on foreign borrowing in a bad timing characterized by the scarcity of foreign resources, as well as the lack of participation and accountability regarding the largest part of this borrowing.

The policy brief is intended to discuss how this overall situation affected the outcomes of the IMF and World Bank programs. The paper explains how the lack of transparency and participation has resulted in socially biased procedures against the most vulnerables and even contradictory procedures.

This policy brief addresses procedures aimed to contain the fiscal deficit (fiscal consolidation). It discusses the following points:

1) What the IMF the World Bank have proposed to achieve fiscal consolidation (wages and fuel subsidies cuts)

2) How did the IMF call for a parallel policy that undermines this objective (monetary policy)

3) Alternatives that could have achieved the same objective without incurring such high social cost.

Fiscal Consolidation

- Reducing the budget deficit is one of the objectives stated in both the IMF and the World Bank's programs. Or, rather, as the IMF puts it:[1]

> Putting public debt under control: Weak revenue combined with poorly targeted subsidies and a growing public sector wage bill had resulted in large deficits and high level of public debt, nearing 100% of GDP. The fiscal reforms already undertaken as part of the program and the government's fiscal plans for the coming years are putting public debt on a declining path, which is essential for stability. As a result, the interest bill (which is now as high as 30 percent of total budget spending) will decline, freeing public resources for priority spending.

Both the WB and the IMF programs rely on cutting spending on wages in the government sector and reducing energy subsidies to achieve their objective. They also rely on the Value Added Tax (VAT) as the sole source of increased public revenue (2.5% of GDP) (IMF, P. 5).

I- Reducing the public sector wage bill

The two programs have chosen the wages item as one of the most important means to narrow the budget deficit, based on the fact that the revolution resulted in social demands related to improving wages. This led to an increase in government wage expenditure which reached 8.5% in 2014-2015, compared to 7% in 2011-2012.

However the IMF is more adamant about cuts as it aimed to reach a government wage expenditure of 6.3% of GDP in 2019-20 (WB, P. 16), compared to 7.3-7.4% sought by the IMF. (IMF, P. 30).

The government is committed to achieving this goal by restricting new appointments and fixing allowances of some employees in certain ministries, rather than increasing them annually. This second procedure would generate a saving of almost 1% of GDP per year (IMF, p. 13).

1 From a note the IMF staff sent as a comment on this policy brief.

Figure 1: The ratio of government wages to realized and expected GDP:

Source: IMF document data p 13.

Why did the bill increase?

Contrary to the World Bank document's data that wages were the major reason behind the increase of government spending (see blue block), Figure 2 shows that interest came in first in terms of increasing the share of expenditure (stripped block) and thus is ought to be considered in terms of containing the deficit.

The biggest increase in the wage bill was in 2012-2013, for a reason completely unrelated to setting a minimum government wage, which targeted only a very small segment of the public sector employees (120,000 employees, almost 2% only of total government employment) (Jebali, 2011).

The reason for the increase is one of the decisions of former President Hosni Mubarak, taken in 2008, in preparation for passing on the power to Gamal Mubarak and to contain the expected popular anger. This decision granted social benefits to public sector employees amounting to 30% of the basic wage.[2] Then, in accordance with government procedures, the allowance would be included in the basic salary (the wage on which social insurance is calculated) five years after its approval. This measure alone increased the bill by 18 billion Egyptian Pounds in FY 2012/13.

2 According to an interview by the researcher in 2012, on the developments related to general budget with Abdel Fattah al-Jebali, advisor to the Minister of Finance, and later to the Minister of Planning after the revolution (it has been a tradition after the 1970s that Mubarak grants a 10% annual allowance). The news were also announced in April 2013: http://www.youm7.com/story/2013/4/11/%D8%A7%D9%84%D8%AA%D9%86%D8%B8%D9%8A%D9%85-%D9%88%D8%A7%D9%84%D8%A5%D8%AF%D8%A7%D8%B1%D8%A9-%D8%B6%D9%85-%D8%B9%D9%84%D8%A7%D9%88%D8%A9-2008-%D9%84%D8%B1%D9%88%D8%A7%D8%AA%D8%A8-%D8%A7%D9%84%D9%85%D9%88%D8%B8%D9%81%D9%8A%D9%86-%D8%A8%D8%AA%D9%83%D9%84%D9%81%D8%A9-18-%D9%85%D9%84%D9%8A%D8%A7%D8%B1/1014984

Is the wage bill too large?

- The average public sector wage bill during the period 2000-2012 in Egypt accounted to 8% of the GDP. In other words, the wage increase after the revolution made insignificant changes to this bill compared to the average during the first decade of the twenty first century.
- By international comparison, the wage bill in Egypt is rather low. The average public sector wage in middle-income countries was 9% of GDP, while in high-income countries and in OECD countries it was 11%, in sub-Saharan Africa it reached 10% (Wael Jamal (ed.) 2017, P. 150, 152)
- Government employment as a percentage of the total population in Egypt is 6.5%, compared to 5% in middle-income countries and 8% in high-income countries, where the quality of public services is high (ibid., P. 154).

II-Energy subsidy

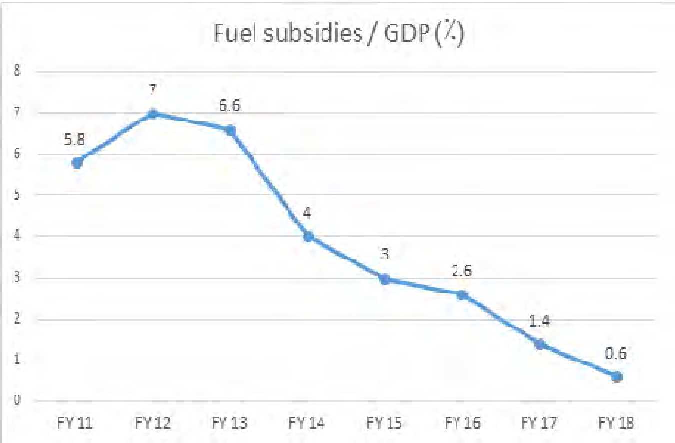
The IMF and the World Bank agreed on the second procedure aimed to contain the budget deficit by reducing energy subsidies. This includes electricity and fuel subsidies.

- **Electricity:** The process began in July 2014 when fuel prices were adjusted between 40-78% and electricity tariffs rose on average by 31%. In the case of electricity, an explicit five-year tariff trajectory has been announced. The Egyptian government has already made three consecutive [electricity tariff] increases until August 2015. Electricity tariffs were increased by an average of 40% effective July 2016, and will be increased further in 2017/18 and 2018/19, with a view to achieving cost recovery in the coming year (IMF, P 56).
- Two striking issues are worth mentioning: The World Bank's document does not address the scale of increases applied to the industrial and services sectors, which account for about half of the electricity consumption in Egypt. Second: the government decided with the approval of the World Bank to exempt large consumers from the last two price increases. The agreement (P. 33) stipulates that

the government will increase the average price per kilowatt-hour to 0.45 pounds by increasing the price only on the average consumption segments, while exempting the two highest consumption segments.

- Regarding fuel subsidies, the plan is also to raise the prices gradually over five years, so that subsidies are completely lifted and cost is covered. Figure 3 shows the evolution of the volume of achieved and expected subsidy.

- The World Bank's program aims to cut the energy subsidy bill by half in the period 2014-2017, to 3.3% of GDP (WB, P 34), while the IMF would see its target of 0.6% reached by fiscal year 2018-19.



Source: Data in IMF document, p. 28

The IMF program noted that "The program is a break with the past in many important respects... subsidies reform removes a preference for energy and capital intensive industries to make room for smaller and more labor intensive businesses to grow"(p.18). However the program took no step in this direction, as we shall see later.

Fact: Why is the energy subsidy bill expected to remain large and hidden?

The World Bank admits that the biggest cut to the fuel subsidy bill so far has been the result of the steep decline in international oil prices, bringing down subsidies as a percentage of GDP from 6.6% to 3.3% between the fiscal years of 2014 and 2016. The increase of price contributed to the cut in the subsidy bill by 40% according to the World Bank loan document (P. 12) compared to 60% due decrease due to lower world oil prices.

- The biggest cut was due to the increase in fuel prices for the household sector, which saw prices rise twice in two years. The industrial sector and the tourism sector remained relatively secure, witnessing one increase only and at rates lower than the increases in the household sector. The price of gas supplied to factories has been raised from $ 1.7 to $ 3 (about a quarter of its world price). The LPG price has also been increased by 87.5% for both the households and tourism sector (less than a quarter of the cost according to the World Bank document).

- The upcoming increases in energy prices will not be borne by the industrial sector, according to Mohamed al-Sewedy, head of the parliamentarian Support Egypt coalition and head of the Federation of Egyptian Industries (contrary to what the IM Fund and the WB call for) (enterprise, 2017).

When the program defines fuel subsidies in the official document of the loan (P. 69), it does not include in its definition natural gas as one of the three largest types of subsidy next to LPG and the solar energy. Natural gas subsidies represented 1.6% of GDP (in 2011), according to another IMF study.[3]

- The IMF has not called for increased disclosure and transparency with regard to the volume of corporate subsidies versus subsidies to the household sector.[4] Most likely, companies still enjoy the bulk of energy subsidies. The question is whether we will soon be facing cross subsidies: whereby consumers will pay the price of subsidized energy for producers.

- A World Bank study pointed out that producers benefiting from energy subsidies are primarily "politically connected" firms or those loyal to the Egyptian regime. In 2010, subsidies to energy-intensive sectors accounted for 2.9% of Egyptian GDP or USD 7.4 billion. [...] politically connected firms appear to be concentrated in energy- (and capital-) intensive manufacturing industries, such as base metals, cement, plastics, textiles, and ceramics etc... (Diwan et al., 2015, p. 14). The same study found

3 The government claimed that the natural gas is not subsidized anymore, because of the decline of current international prices, putting it at 3.2 dollar the unit. But it actually ignores the cost of liquidification and transport.

4 The IMF responded to this in a written comment on this paper as follows: "We welcome efforts to increase the transparency of energy subsidies. In fact, developing a comprehensive energy sector reform strategy, involving independent consultants and improving the efficiency of EGPC are part of the program." Yet, the energy sector reform strategy is not made public to date.

that 81% of industries with at least one (broadly defined) politically connected firm are highly energy-intensive. (ibid., P. 14).

Alternatives

I- Wages:

The social justice requirements should have stipulated the following:

1) The reduction in the wage bill must be limited to the remuneration of senior civil servants.

2) This reduction should be calculated after obliging the government to merge all private funds, which in turn conceal a large part of the income of senior officials, thus enhancing the fight against corruption and limits disparity of incomes within the government sector.

3) Education and health requirements should not be affected by the freezing in the rates of appointment of civil servants. Moreover, a plan must be developed to transfer the surplus in administrative civil servants from the public sectors where labor force is accumulated to service providers' categories where possible.

II-Energy subsidies

According to the requirements of social justice:

1) **Electricity subsidies:** Cross-subsidy system should be reinstalled, whereby the segment of large consumers would pay a price higher than the cost, covering the value of subsidies given to electricity users from among the poor, and thus the cost would be covered while social justice would be achieved.

2) The government should begin a subsidy cut program of large companies (from among those affiliated to Mubarak's regime, according to a recent World Bank study), before making large segments of citizens responsible for the loan repayment bill.

The subsidies item in the public budget must be published in line with the IMF Government Finance Statistics Manual 2014, showing subsidies to companies (private and public each separately) compared to subsidies to individuals. The World Bank and IMF noted the increased transparency of public financial statements. However, this increased transparency is by far not consistent with the best practices detailed in the IMF Manual. In fact, the IMF only requires the Government to abide by the 2001 Manual, of which the IMF issued two updated versions (2007, 2014).

III- Is reducing deficit and the public debt the real goal?

In a nutshell, it could be said that The IMF is imposing measures on the Egyptian government that contradict with the objective of fiscal consolidation. For instance, the devaluation of the pound led the increase of the budget deficit by doubling the subsidy bill and the foreign debt payments. In addition, the monetary policy also imposed by the IMF led to the surge of the interest payments on public debt, which also contributes to the increase of the budget deficit. Third, the fiscal policy approved by the IMF (and the WB) led to the loss of important public revenues. This section explains in details these remarks.

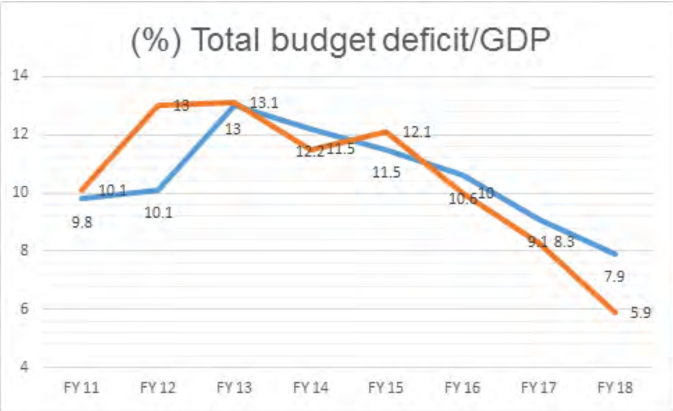
The World Bank requires Egypt to reduce public debt (as a percentage of GDP) to 7.4 in fiscal year 2018-19 (WB, P 12) under the guise of enhancing fiscal discipline. Therefore, the Government shall be committed to:

1) Increasing revenue through VAT, a tax that is regressive by definition and hence, contrary to the concept of social justice. As it affects the poor more than the rich. In contrast, the World Bank required the government to reduce the maximum tax rate (reaching on the richest from 25% to 22.5%). This is a measure that cuts public revenues, hence contradicting the goal of fiscal consolidation, let alone it increases the poor distribution of income and wealth in Egypt.

2) Carrying out procedures aimed at calculating the Government's potential obligations.

Concerning the overall budget deficit, the IMF appeared more aggressive and socially more hostile than the World Bank (see figure 3).

Figure 3: Actual and expected total deficit according to the IMF and the World Bank



Orange: IMF - Blue: World Bank

NB: The IMF's data represent the IMF's deficit calculations, while the World Bank's data represent the Government's calculations. Therefore, we note that the first are higher with respect to already achieved rations while the target ratios are more severe.

The IMF aims to reduce the overall deficit from 12.1% to 4.7% during the program implementation period. However, it only published the details of the program procedures concerning the first 18 months (half of the program period). So, it is not entirely clear what are the measures that will be implemented in order to achieve this goal.

According to the IMF, the achievement criterion is the realized primary deficit to GDP ratio, which is the ratio of total deficit minus interest.

This basically means that the Fund and the Government have agreed to ignore the budget deficit as a measure of success of the goal of fiscal consolidation.

It also means turning their backs to the biggest source of the budget deficit widening, which is the rising interest payments on public debt over the past six years (see figure 1).

These payments account for almost one third of overall public spending, and became the largest item in the budget, surpassing for the first time the wages chapter. The IMF mentioned this more than once in the loan documents, but did not address the problem.

The overall fiscal deficit widened from 7–8% of GDP prior to the revolution to 10-13% thereafter. Public debt increased from 70% of GDP in 2009/10 to 89 percent in 2014/15 (fiscal years end in June), and interest payments reached almost one third of total budget spending (nearly 9 percent of GDP). The deficit was primarily financed through borrowing from the banking system, about one third of which was direct financing from the central bank. (p.5).

On the next page of the same document, the IMF states that in 2015/16, "interest payments increased by 0.9%of GDP due to higher public debt. As a result, the 2015/16 deficit widened to 12.1% of GDP, compared to the budgeted 8.9%, and general government gross debt reached almost 95 % of GDP.

The monetary policy contradicts the goal of reducing the deficit:[5]

The IMF fully liberalized the pound against the dollar and this was accompanied by a monetary policy based on raising interest rates (IMF, P 9). This would entail an increase in the interest bill on government debt.

- The program specifies that the interest rate must be increased in parallel with the raising policy rates by 300 basis points, and the introduction by the government of treasury bills at an average interest rate of rate of 17.5%, in order to contain the first round effects of inflationary pressures (IMF, P 52).
- The idea behind this measure is to withdraw liquidity from the market, in addition to discouraging private investment and consumption, so as to lower domestic demand and curb inflation. This would create a state of temporary deflation, which affects growth, and then employment.

Social impact: This procedure leads to distributional effects in favor of the most affluent groups, resulting from a two-way interaction:

1) The increase in interest means that the banking sector will benefit directly from the treasury bills holders, by increasing their profits resulting from a non-risk income. A limited number of banks control this activity, according to the Ministry of Finance website.

2) While the IMF — and the Government — aim to control the budget deficit, the floating procedure

5 The IMF responded to this critique as follows: "*The program targets the primary balance of the budget because, unlike the overall balance, it is directly under government's control. It is important for monetary policy to focus on a different goal, i.e. controlling inflation, which as the report also correctly mentions has adverse effects on income distribution*".

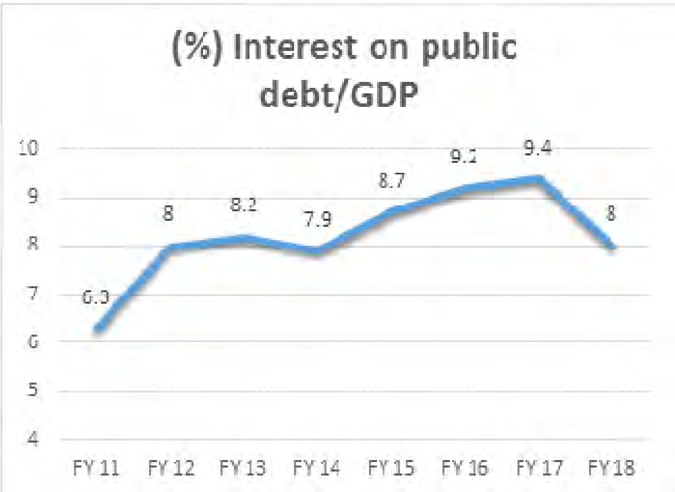
and the interest rate hike widen the budget deficit.

The flotation led to increased subsidies on goods imported by the government, which were calculated on the basis of the exchange rate of the dollar equivalent to 9 Egyptian pounds. Thus, the purchase bill of these commodities (mainly fuel and food commodities) increased in Egyptian pound due to the flotation.

Despite the increase in the prices of some of these commodities, the difference still means that the subsidy bill has exceeded the amount set in the original budget. Foreign government debt payments have also almost doubled .

In turn, the interest rate hike will lead to an increase in local public debt interest item, which accounts for the largest part of government spending, depriving citizens of public funds that were supposed to be used for improving social services. Rather, these funds go to the affluent categories having surpluses to invest in treasury bills, while it would have been more socially useful to impose taxes on the high incomes of these categories instead of helping them increase their wealth. Figure 4 shows how interest on public debt has increased, and how the IMF expects the increase to continue for two more years before slightly declining.

Figure 4: Increasing interest rates on public debt to GDP



Source: IMF, P. 28

NB: interest rates continue to increase for four successive fiscal years despite the reduction of the budget deficit (Figure 3).

Facts:

- Instead of admitting the difficulty of achieving a reduction in the overall deficit, due to the high interest rate imposed by the IMF, an agreement was reached between the IMF and Egypt to measure progress based on the "primary deficit to GDP" criterion, after excluding the effect of interest payments.
- The Egyptian government became in a situation where it is increasing its borrowing (external and internal) in order to service its debts. This will entail further increase of interest rates due to the fragility of the financial situation (as explained by the Annexes on External and Internal Loans Sustainability in both the World Bank and IMF documents). Socially, this means further abandonment of constitutionally binding social spending (on education, health and research) or other social spending, such as improving public services and quality of life in disadvantaged areas.
- The decision to raise the interest rate is a biased decision in favor of the higher income classes, aimed at compensating the holders of government securities for the depreciation of the pound rather than absorbing liquidity to reduce the impact of floating on inflation. The evidence is that this tool has so far failed to contain inflation. Moreover, inflation due to flotation is detrimental for the lower income classes, leading to their impoverishment.
- The IMF failed to predict the inflation to increase as much as a result of the flotation decision (rising continuously to reach more than 30% in February). Neither the government nor the World Bank and the IMF assessed the cumulative inflationary effect (floating + increase in energy prices + VAT) on poverty as required by the rules of the World Bank and the IMF in the event of an agreement on a procedure with social implications.

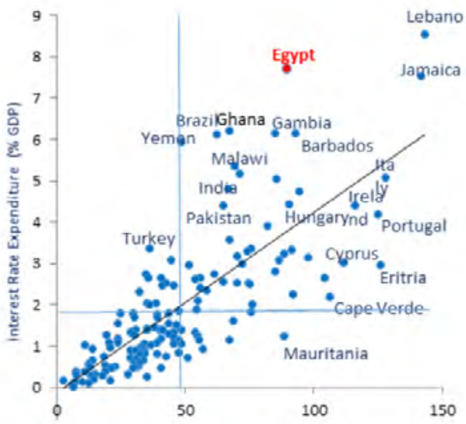
The following recommendations should be able to address the widening budget deficit, while fulfilling the requirements of social justice:

- The reasons for higher interest rates must be analyzed and the interest rate should be subject of re-consultation with the Central Bank of Egypt, especially since the cost of servicing public debt in Egypt is higher than that of countries with the same size of public debt. (See figure 5).
- A part of the domestic public debt must be restructured to reduce its cost, in order to reduce

interest payments, to make room for increased social spending.

- The government should not have resorted to full floating to avoid inflation surges, till the capital flight phenomena is appeased, or regulated (taxing is one option, commit to fight tax avoidance practices is another option).

Figure 5: Interest payments as a percentage of GDP in different countries



Source: The World Bank, 2015.

Other social friendly alternatives to reduce the budget deficit:

- The IMF staff correctly points to the fact that tax revenues in Egypt are very low, adding that : "For the state to be able to deliver adequate public services and meet its constitutional mandates on increasing spending on health and education it is imperative to increase tax revenues. We are in constant dialogue with the authorities, including by providing technical assistance, on designing tax policy and tax administration reforms that can increase revenue in a socially fair way".

- Stimulate government revenues, especially the revision of the tax system, on the one hand, to achieve justice in terms of the tax burden and on the other to raise the taxes to GDP ratio (currently less than 13%, less than the world and the OECD averages).

- The implementation of the VAT must be accompanied by a progressive tax package on incomes and wealth (IMF, 2015).

- Capital gains tax: Egypt is ranked the eighth worst country in terms of wealth distribution (Credit Swiss, 2014). The reasons behind this include the absence of taxes on capital (wealth), (taxes on non-used real estate property and land, inheritance taxes, taxes on unoccupied houses (10 million units) or any kind of estate (stocks, deposits, etc.)) and the sale of real estate, lands and others.

- Taxing capital gains cumulated on the stock market (especially on merger and acquisition transactions), in order to reduce the budget deficit. This alone would increase revenues by more than 3 billion EGP a year.

The Arab NGO Network for Development works in 12 Arab countries, with 9 national networks (with an extended membership of 250 CSOs from different backgrounds) and 23 NGO members.

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