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“The missing variable: a critical assessment of the 2016 IMF program to Egypt and its social implications”

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Index

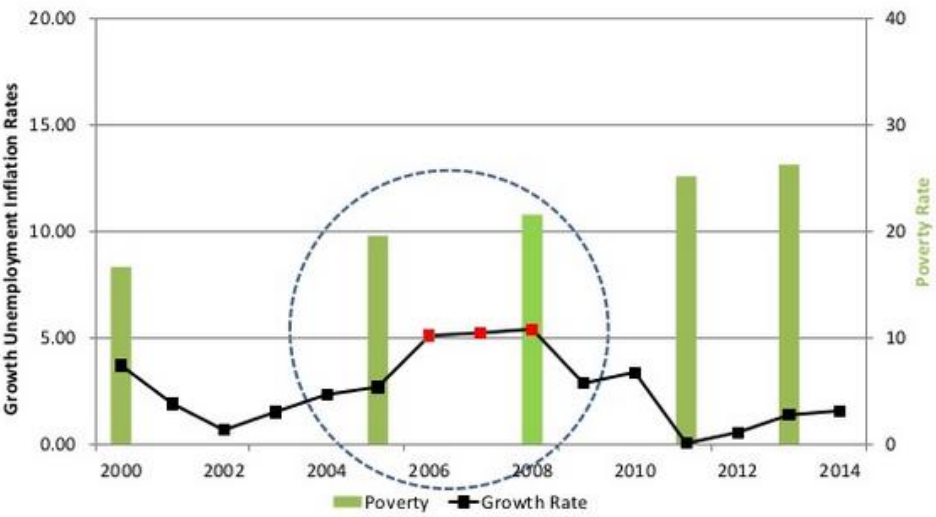
Following the discussions for the disbursement of the third instalment of the IMF Extended Fund Facility (EFF) to Egypt, in November 2017 the IMF published an optimistic report on the advancement of the economic reforms agreed as part of the $12-billion loan with the Egyptian authorities. At paragraph (11), IMF staff note that “the outlook is favourable”, with GDP growth projected at 4.8% in 2017/2018 and bound to increase further to 6% in the medium term (2017: 9). This follows other appraisals by IMF Managing Director Christine Lagarde, according to whom the Egyptian authorities and central bank have “set the Egyptian economy on a path to stability and growth” (IMF, 2017). Surprisingly, a missing variable is overlooked in all IMF communications, reports and growth scenarios, despite its growing role in the Egyptian economy. The silence over the increasing power of the military in virtually every realm of Egyptian society suggests that IMF growth forecasts are highly underestimating the political reality. Hence, this essay aims at shedding light on the inconsistencies of the current IMF program through a thorough assessment of the most recent 2017 report. Following an introductory part aimed at providing some background on the events leading to the IMF loan, this essay will analyse the main targets of the IMF program to Egypt and evaluate their implementation status. It will conclude that the neglect of pressing socio-political factors risks shifting the entire burden of adjustment on the bottom strata of society, while also compromising the success of the economic plan.

Background to the implementation of the IMF loan

The long-delayed IMF loan was agreed amid mounting problems. The central bank was running out of foreign reserves and the acute shortage of foreign exchange was starting to affect the private sector; a high level of public debt, up from 2008 to contain the negative effects of the crisis, and large fiscal deficits were worsening Egypt’s borrowing position; and the slowdown in economic growth, coupled with high unemployment rates, was becoming unsustainable for the population at large (Momani, 2018: 4-5).

The problems were largely a legacy of the Mubarak era, where the puzzle of increasing growth and poverty rates finally disentangled itself in the 2011 Revolution. The high levels of GDP growth between 2003-2007 were the result of capital deepening sustained by large capital inflows, mainly in the form of workers’ remittances and FDI. Yet, as some scholars had early warned (Achcar, 2009), the drivers of this success story could be identified in a change in supply-side conditions, rather than in the 2004 domestic economic reforms. In particular, the boom in revenues experienced by the GCC countries in the years preceding 2008 accounted for 45% of the increase in remittances and 56% of the net FDI into Egypt between 2006 and 2007.

I. The growth with poverty puzzle. Source: IFPRI (2016).



However, the large capital inflows did not contribute to poverty alleviation given that the cronies connected to Mubarak enjoyed most of the benefits. As the financial crisis erupted and the growth slowdown hit Egypt, the unsustainability of the economic system was evident. Thus, the revolution was the outcome of the unequal capital accumulation that had failed to create jobs for Egypt's growing population, especially the youths, while at the same time neglecting their rights. Yet, as this essay seeks to show, the inability to manage the economy and keep cronies under control has continued after the Mubarak era and is a further reason for the request of financial assistance to the IMF.

A critical assessment of the loan

The $12-billion loan from the IMF, the largest in Egypt's history, is conditional on the intervention in three main areas: monetary, fiscal and structural reforms. The policy recommendations follow standard IMF practice by encouraging exchange rate floatation, the introduction of a value-added tax (VAT), as well as fiscal budget consolidation through reduction of subsidies. However, the complete neglect of the current political economy context risks worsening the situation by not tackling the most salient issues. These policies will risk further alienating the people that are most in need of reforms while keeping the status quo in matters that regard the corrupt state apparatus.

The following sections analyse the IMF recommendations and shed light on the wider political and social problems that remain unaddressed in the 2017 Article IV Consultation report that followed the discussions held in November 2017 between Egyptian authorities and IMF staff members.

I. Fiscal consolidation: increasing taxes and cutting subsidies… for whom?

Between 2013-2016, the Kingdom of Saudi Arabia contributed almost $25 billion to the Egyptian economy, a clear sign of its support to the new military government (El Dashan, 2015: 207-8). Yet, by 2016 it was unwilling to contribute further money. Hence, raising taxes and lowering subsidies was the most immediate alternative as former general al-Sisi took power in mid-2014. The main reforms of the long-delayed fiscal programme of 2014 include the introduction of a VAT on all goods and services and cuts to energy subsidies. These measures were supported by IMF staff during the negotiations for the 2016 loan, but their implementation remains very controversial.

The VAT was finally introduced in 2016 and features among the set of fiscal reforms that the IMF agreed with Egypt as a condition for the disbursement of further instalments of the loan. The tax was set at 13% for 2016 and increased to 14% in the following fiscal year (Alabass and Mecky, 2016). The IMF usually suggests the introduction of a VAT as a default measure for countries facing high fiscal deficits. In fact, its simple design means that its implementation is relatively straightforward. Moreover, it is also easy to collect and therefore leaves 'less room for "leakages"', that is, tax evasion, thereby allowing countries to quickly increase their revenues (Jarvis, 2017).

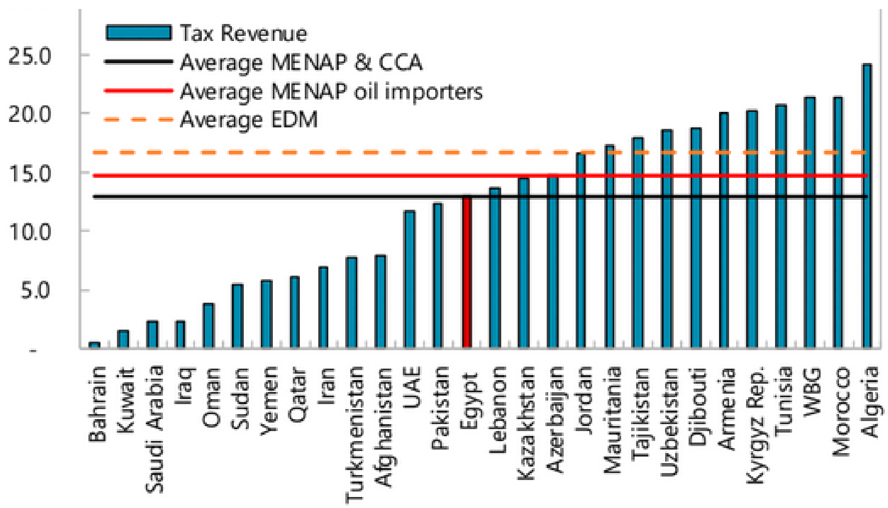
Yet, others point out that the VAT is a highly regressive measure mainly because it is levied at a standard rate irrespective of the income of the consumer (Buenaventura and Miranda, 2017: 6). In turn, this means that by increasing the general price level it imposes a higher burden on poor and vulnerable groups than on high-income groups. Furthermore, the measure also tends to have a much worse effect on women, especially in emerging countries. Because women tend to earn less than men, to be more likely to be employed in precarious informal sector jobs, to provide more unpaid care work and to have fewer entitlements to assets and properties, VAT will risk being not only regressive but also discriminatory (p.8). This is especially important given IMF Managing Director's special attention to social assistance to women during the negotiations of the programme.

Lastly, given the size of the country's informal sector, which in the recent decades has expanded to welcome those unable to find employment in the formal economy, the tax risks imposing higher costs on small unregistered businesses that will have to face higher prices of inputs without being able to redeem the tax payments (Akram-Lodhi and Van Staveren, 2003). According to the IMF, this obstacle would create more incentives for informal businesses to switch to the formal economy, but, given their low productivity and the high costs faced in the highly bureaucratic Egyptian system, this is not likely to happen.

Consequently, although some planned exemptions on specific goods, such as basic food and medicines, will certainly reduce the regressive effect of the measure,[1] this can only be a "quick fix" for increasing the government revenues in a short time period. However, it does not address the deeper and long-term structural problems of the country, in particular the lack of productivity inherited from the Mubarak years and high inequality.

Yet, as the graph below shows, a reform of tax policy is needed, since Egypt remains one of the countries with the lowest levels of revenues from taxation and a concomitant high budget deficit (IMF, 2017: 16). In fact, during the last years of the Mubarak presidency the annual budget deficit jumped to 7-8%, with energy subsidies absorbing one fifth of the expenditures and interest payments consuming another fifth. By 2015, this figure had further increased, with more than three quarters of the budget used for a combination of subsidies (27%), wages in the public sector (25%), interest payments (28%) and repayment of loan capital (15%), so that a mere 5% was left for other expenditures (Springborg, 2017b: 3-5).

II. Tax revenues in 2016 as a % of GDP. Source: IMF (2017).



Note: EDM stands for the average tax revenue from Emerging and Developing Markets consistent with the WEO classification.

[1] Yet, other important products that were initially supposed to be exempted have been excluded, such as imported vegetables and wheat.

This has prompted the government to reduce fuel subsidies, which according to the IMF (2017) mainly benefit capital-intensive industries and the richer strata of the Egyptian society. Indeed, during the Mubarak regime, subsidised energy resulted in overinvestment in capital-intensive and inefficient industries, such as cement, steel, construction and ceramic (Springborg, 2017b: 6). This problem is widely shared with the oil-rich economies of the Gulf, which are now struggling with economies that are undiversified and with little scope for employment creation.

However, the implementation of the measure leaves some doubts. In fact, in July 2017 the price of cooking gas used by poor Egyptians increased by 100%, while the cost of fuel oil used by cement factories, where many politically connected firms are, was only expected to rise by 40% (Reuters, 2017). In addition to this, in its November 2017 report, the IMF suggested that the Egyptian authorities should take into account further reforms in their tax system by vaguely alluding to a more progressive system of taxation (p. 14). Yet, the increase in VAT and cuts to subsidies to free up revenues to spend on social programmes come after the government approved a reduction in the tax rate for the top earners from 25% to 22.5% in 2015 (Momani, 2018: 7).

Hence, if the larger political economy context is not taken into account from design to implementation, including the possible gender or class bias of certain policies, the latter will not result in an economic recovery. For instance, the measures introduced for mitigating the negative effects of inflation on the poor, such as smart cards for the purchase of subsidised food, are inadequate and largely ineffective for the rural poor, who are often illiterate and unable to apply for them.

II. Inflation target and macroeconomic stabilisation

The target of moderate inflation, coupled with the floating exchange rate in November 2016, was recommended by the IMF in order to stabilise the economy and correct the current account deficit by devaluing the domestic currency. Indeed, a flexible exchange rate can work as an automatic stabiliser and mitigate the impact of recessions, as well as prevent foreign reserve shortages such as the one that compelled the central bank to impose currency controls in 2014, thus causing losses for some businesses unable to import raw materials (Springborg, 2017b: 4).

At the same time, the central bank was supposed to contain the expected rise in inflation with higher interest rates, up by 700 basis points to reach 18.75% in July 2017. Yet, the increase in remittances and capital inflows following the devaluation more than offset the restrictive monetary policy of the Central Bank of Egypt, thereby resulting in inflation jumping from levels of 8-15% throughout 2011-2016 to 22% in December 2016 and to an all-time-high 35% in July 2017, after further subsidy cuts were implemented (IMF, 2017). Thus, the level of dollar liquidity of banks improved, workers' remittances grew by 13% to reach $8 billion in 2017Q2 and FDI showed some signs of improvement, but the devaluation also severely affected the prices of imports and, consequently, people's purchasing power. As the Egyptian pound depreciated by half against the US dollar, the price of basic imported foods, as well as inputs for medicine production, soared (Haddid and Youssef, 2016). While VAT exemptions for basic goods were supposed to mitigate the burden on the poor, the rise in inflation is likely to have offset these preventive measures, especially given Egypt's high reliance on imported food.

The 2017 Article IV Consultation report positively describes the gradual decline of inflation, which has further decreased to 17.1% in January 2018. However, economists seem to agree that this is the result of a strong base effect, rather than a sign of economic recovery. Food producers confirmed that further price hikes were avoided due to the inability of the market to absorb them (Gaballa, 2018). Hence, the decline in the prices of poultry, meat, some vegetables and beans registered in December seems the result of a lack of demand, caused by the sharp decrease in purchasing power faced by Egyptian households in July 2017, when inflation hit 35% following the increase in fuel prices and the further rise in the VAT rate.

In this case, the lack of sequencing of the reforms severely hit the cost of living of the average Egyptians and the safety nets put in place were not sufficient (Momani, 2018: 4). A communication issued by the IMF in January 2018 stressed the importance of making growth more inclusive, yet officials are prioritising macroeconomic stability at the expense of social protection.

III. Increasing the competitiveness of the private sector

The last chief intervention of the IMF tackles the lack of competitiveness in the economy and particularly focuses on the private sector. Given the growing size of the Egyptian population, the IMF (2018) predicts that 700,000 new jobs need to be created every year and this can only be possible if the private sector flourishes. For this goal, the IMF recommendations include streamlining industrial licenses and improving access to land and credit. Among these, the reform of the bankruptcy law was passed by the government in

January 2018 and is expected to improve the investment environment by encouraging small businesses to get more credit thanks to the elimination of prison terms for insolvent investors (Magdy, 2018). In fact, as Diwan et al. (2014) note, small businesses tend to get less credit out of fear of becoming insolvent and going to prison. The measure would further simplify the debt restructuring procedures by allowing viable companies to re-enter the market more quickly. Yet, doubts remain in regards to the extent to which such reforms will have a real impact on the economy.

In fact, a common problem among many emerging economies, and Egypt in particular, is the arbitrariness with which laws are implemented. For this reason, the World Bank Doing Business indicators tend to be highly unreliable since they assess the ease of doing business in a country by looking at *de jure* changes in the regulation, but they fail to take into account the large room of interpretation and implementation that is usually left up to the public authorities. In this context, the passage of the law 13 in April 2017, which invests the president with the power to appoint heads of judicial bodies, further eroded the already dubious impartiality of the judiciary (Auf, 2018).

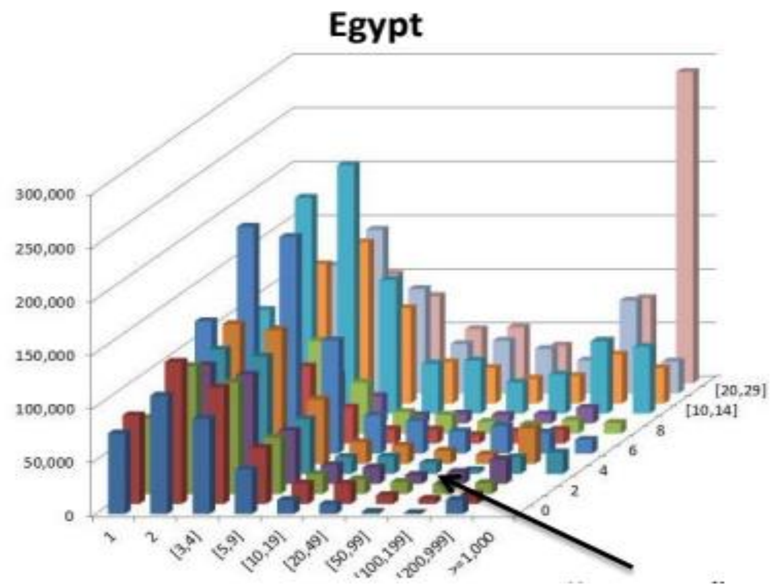
Consequently, and most importantly, this shows that the IMF severely underestimates, intentionally or not, the risk attached to the overwhelming power of the military and its increasing involvement in the Egyptian economy. The second review of the Extended Fund Facility points to some internal and external risks that may hamper the projected economic reform track, among which figure the “opposition by vested interests”, the increase in global oil prices and the worsening of the regional security situation (IMF, 2017: 9). However, no mention is made of the need to reduce the army’s presence in the economy nor of the need to impose real estate taxes on the 600 military-run businesses that are currently exempted.

The 2011 Revolution *de facto* offered to the army the chance to re-establish their power after Sadat and Mubarak had tried to distance it from the executive (Springborg, 2017a: 478). The assassination of Sadat, and later the toppling of Mubarak thanks to the decisive support given by the Supreme Council of the Armed Forces to the manifestations, show that the army remained nonetheless very active during the past decades (Roll, 2016: 24). After the 2013 coup, it was also able to extend its power within the economy. Since August 2013, the Armed Forces Engineering corps have been assigned 1,350 development projects, including housing, health and education, and they are also involved in the New Suez Canal mega-project. The economic power of the military is difficult to establish, but estimates range from 2% to 30-40% of GDP, as its economic interests date back to the Nasser era (El Dashan, 2015: 212-3).

Consequently, the fear is that the change in regime from Mubarak to al-Sisi may have simply affected the type of cronies within the system, but not corruption itself. Mubarak had tried to make it a family business, with politically connected firms with close ties to his family. On the other hand, under al-Sisi the connections with the small and authoritarian decision-making elite within the military are much more important, although some old cronies have been reaccepted in the system (Springborg, 2017a: 479). This means that while the system is changing, political connections still matter more than economic competitiveness for businesses' success, thereby constituting a severe risk for the future of the economy. In particular, as Diwan et al. (2014) show, given the small availability of credit to the private sector, politically connected firms tend to benefit from most of the loans, thereby crowding out non-connected businesses.

Annihilated under the dominance of military firms, a truly competitive business elite is unlikely to arise. Indeed, the presence of the military in the private sector deters new businesses from entering the market out of fear that they will not be able to compete with politically connected firms. These obstacles are particularly important for Egypt's economy given the lack of small and medium-sized enterprises (SMEs) able to create high-quality employment, fuel innovation and increase economic diversification. According to Loewe et al. (2013: 3), in 2006 SMEs provided only 3% of total employment and accounted for a mere 0.13% of all formalised Egyptian companies. On the other hand, micro enterprises with one to four employees represented 92% of all companies and large firms with more than 100 employees were less than 1%. This phenomenon, referred to as the "missing middle", is responsible for the low export levels and lack of technological innovation that plague the Egyptian economy.

III. Employment distribution by establishment size and age. Source: Diwan et al. (2014)



Concluding remarks

In conclusion, the growth plan the IMF has embarked upon is not as robust as the officials believe. The proposed measures are out of touch with the politico-economic reality and impose a significant burden on the poorer strata of the Egyptian population. In particular, currency devaluations, fiscal consolidation and business reforms will only produce short-term effects, but cannot change the underlying economic structure if the root causes are not addressed. Tackling the concentration of assets owned by the military, introducing more progressive forms of taxation and repealing tax exemptions for the top income brackets and the military-run businesses could be a first step in this direction. In addition to this, creating the effective conditions for new SMEs to enter the market and create new employment is fundamental for the successful recovery of the economy.

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