# EGYPT:

## BRIEFING ON

## THE RECENT WAGE AND SUBSIDIES INCREASES AND OFFSETTING BUDGETARY MEASURES

*JUNE, 2008*

*All projections included in this report constitute the best judgment of the Ministry of Finance based on existing domestic and international considerations and are subject to change accordingly.*

The Macro Fiscal Unit

Ministry of Finance Towers

Nasr City,

Cairo-Egypt

Fax: +(202) 23421303

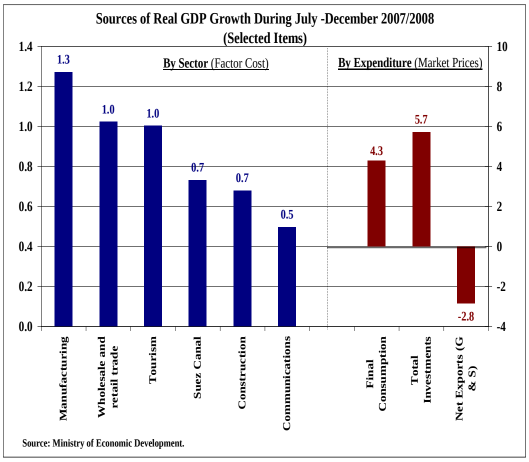
Website:

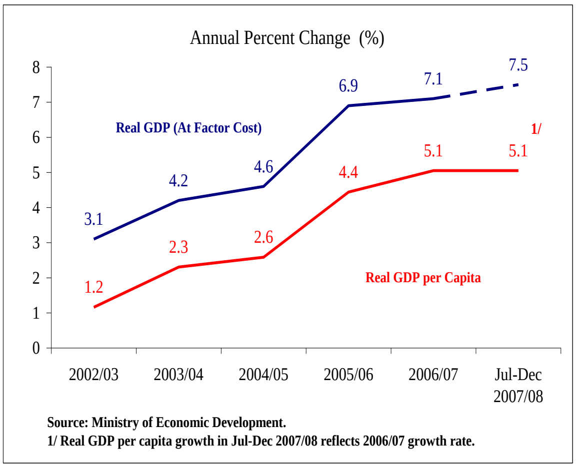
www.mof.gov.eg

## Introduction

Stemming from broad based institutional and structural reforms, almost on all fronts, the Egyptian economy is continuing on its strong growth path for the third consecutive year; reaping the fruits of such comprehensive agenda and confidence of local and international investors. The Egyptian economy achieved real growth of 7.2% (market prices) during the course of the first semester of 2007/08 (7.5% at factor cost), and is expected to witness a similar growth pattern for the entire year, slightly higher than the 7.1% achieved in FY 2006/07, but up from 4.1% just half a decade ago in 2003/04. Recent indicators assure that such growth is gaining momentum as well as sustainability. As sources of economic growth are becoming more diversified - with the manufacturing sector leading the current growth wave, productivity and per capita income are increasing, institutional and structural reforms are continuing on reasonable pace, external sector gaining resilience and diversity, fiscal indicators improving steadily, and financial and capital markets strengthening; a greater element of stability is established within the fundamentals of the Egyptian economy and its overall structure.

With increased confidence in Egypt's economic sustainability, annual net FDI inflows reached US$ 11.1 billion in FY 2006/07 (8.5% of GDP) up from US$ 6.1 billion a year before. Greenfield investment represents more than 46 percent of net FDI inflows witnessed in FY 2006/07. It is noteworthy that net FDI inflows during the period July-March 2007/2008 increased to record US$ 11.3 billion up from US$ 9 billion during the same period last year, with net Greenfield investments (oil exclusive) increasing by some 40% during the same period.




A similar expression is elaborately reflected in a note prepared by a recent IMF mission to Cairo during April 2008: *"The reform program has strengthened the economy: (i) economic growth is broad based and robust and unemployment has declined, with reports of skilled labor shortages in several sectors; (ii) financial market indicators are strong, with equity prices at record levels and spreads on Egyptian Eurobonds below the average for emerging market economies; (iii) investor confidence has resulted in large capital inflows, mainly of FDI, which have more than offset the deterioration in the current account balance resulting from buoyant domestic demand and trade liberalization; (iv) international reserves are substantial and reserve cover is comfortable; and (v) the path of the public debt-to-GDP ratio is firmly downward-sloping. There is every reason to be confident that the planned deepening of reforms will sustain the improvement in economic performance".*

## The International Price Shock

Like other emerging markets, the Egyptian economy was hard hit with the ongoing wave of unprecedented price increases of food, energy, and other primary goods. As described by many observers, such wave is nearly unmatched in terms of its magnitude, length, and nature; hitting both supply and demand sides simultaneously, while further fueled by declining growth and significant turbulences in the major world economic centers and financial markets.

Domestically, the impact of the recent price shock was most significant on the middle and lower income groups of the Egyptian society. On average, Egyptians spend some 45 percent of their incomes on food items, while such ratio is significantly higher for lower income groups, reaching some 60 percent for the lowest quintile. There were consequent hard pressures on the budget to preserve social and economic stability as nondiscretionary spending had to increase to help alleviate the impact of such developments on the lower middle income and most vulnerable social groups.

## **2007/08 Outcomes**

In this regard, food subsidies were increased on two steps over the original 2007/08 budget allocations by a total of LE 5.8 billion to some LE 15.3 billion (1.8 % of GDP)[1] to finance higher international food prices, and to disburse additional amounts of rice, sugar and edible oil on rationed cards. In addition, the Parliament approved an increase in energy subsidies for by LE 23.7 billion to LE 60.3 billion (7% of GDP) to cover the sizeable increases in international oil prices. It is noteworthy that larger food and oil subsidies will be deficit neutral for the 2007/08 budget, as will be offset by a combination of equivalent increase in taxes and dividends transfers from EGPC[2], higher tax receipts from other companies, and savings on some expenditure items.

In the meantime, *Fiscal indicators* are improving and consolidation of the fiscal deficit is on track, despite such unfavorable external conditions. The overall deficit for 2007/08 is anticipated at some 6.8-6.9% of GDP, down from 7.5% in 2006/07. *Gross total* budget sector *debt* (domestic + foreign) to GDP is expected to drop by another 13-14 percentage points of GDP to 82-83% of GDP. *Gross Domestic debt* would drop to some 70% of GDP down from 81% of GDP as of end 2006/07, and compared to 101% of GDP in June 2005. It is noteworthy that the *net total (and domestic)*

[1] Egypt subsidizes popular bread which consumes nearly some 8.5 million tons of grains per year, with total subsidies of LE 12-13 billion (1.5% of GDP), in addition to limited amounts of edible oil, sugar, and rice on the rationed cards system with total subsidies cost of LE 2.5-3 billion (0.3% of GDP). After expanding its coverage, the rationed cards system is estimated to serve some 50 million beneficiaries.

[2] Egyptian General Petroleum Corporation.

budget sector debt to GDP is about 14-15 percentage points lower than its gross value[3].

## 2008/09 Approved Budget

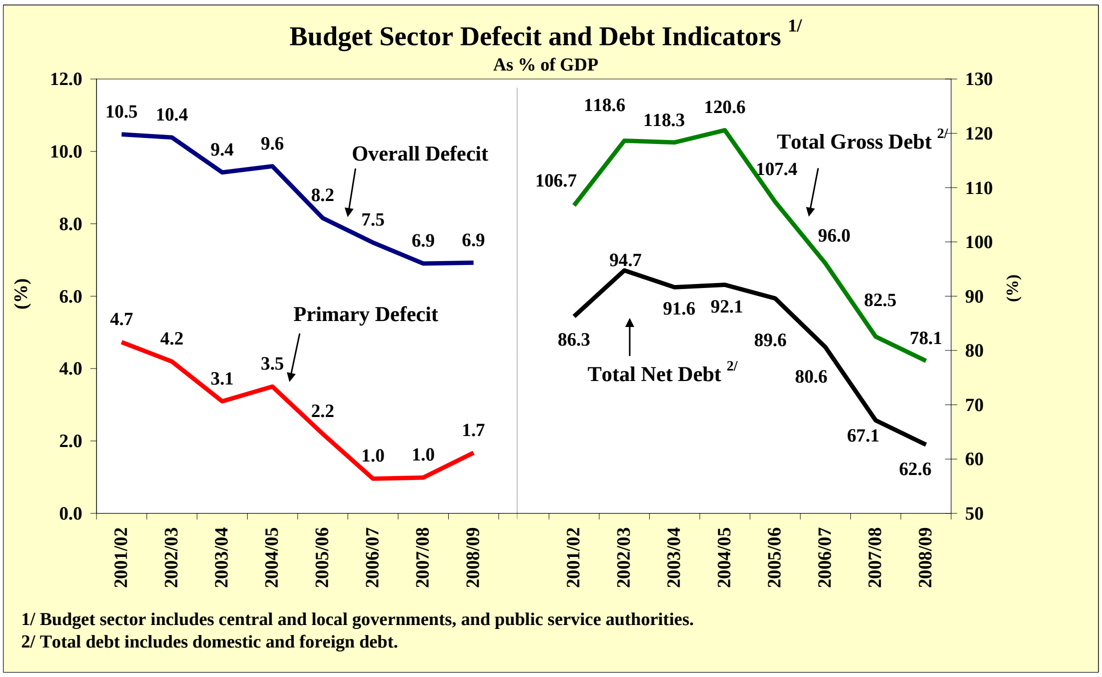
The government assures its commitment to achieving its fiscal and tax policy reforms and budget consolidation agendas, with the budget deficit falling to some 3% of GDP by year 2010/11.

The persisting increases in international food and other basic commodity prices called on a temporary, yet not significant, reengineering of the deficit reduction plan. In this regard, the *overall budget deficit* as approved by the Parliament is estimated to stabilize at 6.9 percent of GDP, similar to preliminary estimates for FY 2007/08, whereas the cash deficit is expected to improve by 0.3% of GDP over FY 2007/08 estimates to 6.6%.[4] Such transitory change will be remedied by a scheduled reform in the sales tax system that will be presented to Parliament during the course of FY 2008/09 session. In addition to its important impact on revenues buoyancy, planned reforms in the sales tax area would generate additional windfalls to the budget in the neighborhood of 2-2.2 percent of GDP.

Meanwhile, the overall *debt position* will continue improving. Total gross debt (foreign and domestic) would fall further to some 77-78% of GDP compared to 82-83% (expected) for 2007/08, and down from 121% of GDP in 2004/05.

[3] Gross debt estimates in this note include the impact of using blocked account balances to retire parts of the outstanding government debt with the Central Bank of Egypt (CBE) calculated at some 4 percent of GDP.

[4] The budget approved by the Parliament is referred to as baseline *budget* in light of its exclusion of any expected additional receipts from measures still in the pipelines such as the new property income tax, or proposed amendments to the income tax law (aiming towards reducing tax avoidance and improving its revenue buoyancy).




In an exceptional move to alleviate the social costs related to unfavorable global price hikes, the Egyptian Parliament endorsed Law number 114/2008 with additional revenues measures to fully finance additional adjustments in wages, pensions, and subsidies in excess to what was presented in the government's original budget proposal. A total of 14.4 billion pounds bill was passed on May 5th, 2008, with a reduction in energy subsidies (LE 7.5 billion), increase in sales tax on cigarettes (LE 1.3 billion), increasing development fees on vehicle licensing (LE 1.1 billion), increasing fees for use of cement raw materials (LE 1 billion), and elimination of few income tax exemptions (LE 3.5 billion). The latter includes: (i) the elimination of tax exemptions on t-bills interest income to seize a long lasting structural bias favoring banking sector lending to the government at the expense of efficient intermediation and market competition, as well as to promote liquidity in government papers secondary market; (ii) seizing tax exemptions on profits attained by education institutions; (iii) elimination of tax exemptions on energy intensive[5] Free Zone companies, operating particularly in the fields of fertilizers, petrochemicals, steel, and LPG manufacturing, liquefactions, and transportation. This will be applied without any retroactivity to sales tax or customs duties on equipment and materials imported

[5] Oil intensive industries include companies working in the following industries: (1) Petroleum manufacturing, (2) gas manufacturing, liquidation and transportation, (3) cement manufacturing, and (4) iron and steel manufacturing. The number of companies directly affected by the newly introduced measures is 37 companies out of a total of 1243 companies working in Free Zones.

by operating projects, or otherwise to be imported by projects under construction (and required by the projects in order to start their operations) for a period of three years from the date of publication of Law 114/2008.

It is noteworthy that the government has taken several measures in reducing energy subsides in the past. The last move was in September 2007, with the Prime Minister decree 1914/2007 which doubled fuel oil domestic prices to LE 1000 per ton, and adjusted the price of natural gas for energy intensive industries to international levels over three phases ending 2009.

**Fiscal Implications of Increased Wages, Pensions, and Subsidies Bills**

| Additional Cost | 2007/08 | 2008/09 | Financing Sources | 2007/08 | 2008/09 |
|---|---|---|---|---|---|
| Increasing monthly take home salary by 30% of base wage | 1.1 | 6.2 | Reducing energy subsidies and increasing sales tax on petroleum products | 1.3 | 7.5 |
| Increasing maximum rewards for local government employees to 75 | 0.4 | 3.0 | Increasing sales tax on cigarettes | 0.2 | 1.3 |
| Disbursing additional quantities of rice, edible. oil, and sugar on rationed cards, and increasing number of beneficiaries to some 50 million people | 0.2 | 1.6 | Increasing vehicle licensing and registration fees | 0.2 | 1.1 |
| Increasing monthly pensions by 20% with maximum LE 100 | 0.6 | 3.6 | Increasing fees on quarries | 0.2 | 1.0 |
| Increasing Energy subsidies | 4.0 | | Seizing tax-exemptions on power intensive industries in Free Zones | 0.1 | 0.6 |
| | | | Seizing tax-exemptions on T-bills interest income | 0.1 | 1.0 |
| | | | Seizing tax exemptions on profits of educational institutions | | 0.9 |
| | | | Seizing forward carry-over of loses | | 1 |
| | | | Higher tax receipts and dividends from EGPC | 2.7 | 0 |
| | | | Other | 1.5 | |
| **Total Additional Uses** | **6.3** | **14.4** | **Total Additional Sources** | **6.3** | **14.4** |

This bill is intended to finance a relatively delayed wage adjustment to government sector employees (some 5.9 million employees[6]), and increase the amounts of rice, sugar, and edible oil disbursed on rationed cards. President Hosni Mubarak announced an increase of 30% to the basic pay for all government employees

[6] Includes employees in the government sector, and economic authorities.

effective May, 2008[7]. In addition, the incentives system to local government employees (3.4 million employees) will be adjusted to a maximum of 75% of the basic wage instead of the currently applied 25%. Monthly pensions will also increase by 20% with maximum LE 100.[8] The total budgetary cost for wages and pensions adjustments are estimated at LE 2.1 billion for 2007/08, and LE 12.8 billion for 2008/09 (1.3% of GDP), whereas additional food subsidies costs are estimated at LE 0.2 billion in 207/2008, and LE 1.6 billion for 2008/09 (less than 0.2 percent of GDP).

Overall, the new budget measures are deficit neutral, and are concomitant with the announced government policy of achieving fiscal consolidation while maintaining adequate social and economic balances. All additional expenditures are targeted towards pressing social needs, while extra resources raised were offset by measures assuring improved income redistribution between the different social groups.

---

[7] On average basic pay represents 25-33 percent of the total take home salary.

[8] It is not likely, however, that the *private sector* will witness similar increases for two reasons: *first*, the private sector has already gone though major wage adjustments over the past 12-14 months, which therefore makes any likely increases relatively smaller; and *second*, the 30% increase to the government employees is not compulsory to the private sector. In this regard, the Minister of Labor and Migration announced that each entity will decide on the proper wage increase according to its own circumstances.

## Summary of Government Fiscal Operations For Budget 2008/2009 In Light of the Application Of Law No. 114 Of 2008

In LE Millions

| | 2007/2008 | | 2008/2009 |
|---|---|---|---|
| | Approved Budget | Preliminary Actual | Approved Budget |
| **Total Revenues and Grants** | **187,239** | **211,916** | **276,795** |
| Tax Revenues | 120,824 | 135,352 | 166,569 |
| Grants | 3,166 | 2,166 | 5,557 |
| Other Revenues | 63,249 | 74,398 | 104,669 |
| **Total Expenditures** | **244,061** | **272,133** | **343,912** |
| Wages and Salaries | 60,344 | 61,710 | 79,039 |
| Purchases of Goods and Services | 16,945 | 16,945 | 23,833 |
| Interest Payments | 51,979 | 51,979 | 52,930 |
| Subsidies, Grants and Social benefits | 64,280 | 91,470 | 134,062 |
| Other Expenditures | 22,864 | 22,864 | 25,788 |
| Investments | 27,650 | 27,165 | 28,261 |
| **Cash Deficit** | **56,823** | **60,217** | **67,117** |
| **Net Acquisition of Financial assets** | **1,946** | **346** | **2,674** |
| **Overall Deficit** | **58,769** | **60,564** | **69,792** |
| **GDP** | **846,800** | **870,000** | **1,008,000** |
| **Cash Deficit In Percent of GDP** | **6.7%** | **6.9%** | **6.7%** |
| **Overall Deficit In Percent of GDP** | **6.9%** | **6.9%** | **6.9%** |