

EGYPT'S DEMOCRATIC TRANSITION FIVE IMPORTANT MYTHS ABOUT THE ECONOMY AND INTERNATIONAL ASSISTANCE



Legatum Institute and Carnegie Endowment for International Peace
in association with the Atlantic Council

FIVE IMPORTANT MYTHS ABOUT THE ECONOMY AND INTERNATIONAL ASSISTANCE

MYTH #1. EGYPT'S ECONOMY IS A BASKET CASE. WRONG.

Egypt's economy is robust and diversified, and it enjoyed significant rates of economic growth prior to the revolution. Provided the newly-elected government renews a commitment to improving the business environment and to redressing the fiscal deficit, there is no reason why Egypt should not grow rapidly again.

MYTH #2. IT IS TIME TO CONCENTRATE ON POLITICS; ECONOMIC REFORMS HAVE TO WAIT. WRONG.

If the transition to democracy is to be successful, Egyptians have to establish the conditions for economic growth and for sustainable public finance. That requires reforms sooner rather than later.

MYTH #3. KEY FISCAL PROBLEMS – SUCH AS SUBSIDIES – CANNOT BE TACKLED ANY TIME SOON. UNTRUE.

At the very least, fuel subsidies can and must be phased out. The subsidies are inefficient, regressive, and are an enormous burden on the country's public finance. Without addressing the problem of subsidies, the country is headed for a deep economic crisis.

MYTH #4. THE EGYPTIAN GOVERNMENT NEEDS BUDGET SUPPORT URGENTLY. APPARENTLY NOT.

Egypt's government has already rejected soft loans from the IMF and World Bank and will instead seek to limit its spending and receive funding from Arab states. Giving the government more money now is unlikely to make a major difference to the transition. Instead, ways need to be found to channel assistance through direct investment in the private sector, public-private partnerships in infrastructure, and civil society.

MYTH #5. THE INTERNATIONAL COMMUNITY HAS DONE ALL IT CAN DO TO HELP THE TRANSITION. UNTRUE.

The United States, the European Union and other external actors can and should do much more to incentivize and support economic reforms, which, in turn, will support the political transition to democracy. We should foster trade and private investment. Specific forms of aid that can facilitate grassroots development initiatives and strengthen the institutions of civil society could have a lasting impact.

EGYPT PROJECT

LEGATUM INSTITUTE AND CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE
IN ASSOCIATION WITH THE ATLANTIC COUNCIL

In summer 2011 the Legatum Institute and the Carnegie Endowment organized a team of economists and experts in international transitions to spend several days in Egypt. In early June in Cairo the group met with business leaders, politicians, economists, international aid experts, and U.S. and EU diplomats, among others. The purpose of the visit was to listen and learn to those best placed to comment on various aspects of Egypt's democratic transition.

The Egyptian revolution is a turning point to be celebrated. In the months and years ahead, the country's future will be decided by Egyptians themselves, of course. But the international community has an interest in a stable, democratic and prosperous Egypt. And a role to play. Egypt is of vital strategic importance to the entire region. With Tunisia, the country stood at the beginning of the Arab Spring. If Egypt fails, the effect of that failure will reverberate throughout the Middle East.

The following report represents an independent assessment of some of the challenges Egyptians face today. We've focused on the economy and the question of international assistance. If political reform is to succeed, we believe Egypt's new leadership will have to deliver on the economic front. What is the current state of affairs? What reforms are now economically necessary? What is politically feasible? How can external actors assist? How can those of us committed to Egypt's democratic future avoid doing harm?

We hope this report can contribute to the debate.

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INTRODUCTION

If the democratic transition in Egypt fails and the country adopts a repressive, authoritarian, or theocratic form of government, the consequences could be profound. Failure in Egypt could lead other countries in the region to turn away from the very idea of democratic reform. Of course, democracy in other countries will rise and fall due to local conditions. Nevertheless, if the transition in Egypt succeeds, and the country acquires a democratic, accountable, and efficient form of government, it is likely to become a powerful example and, ultimately, a stabilizing force in a turbulent region.

The grievances that led to the revolution of January 25 were chiefly political, but old economic grievances played a role as well. The rigged parliamentary elections of 2010, the 'emergency' repressive measures that lasted for decades, and the absence of freedom to speak and assemble robbed Egyptians of their sense of dignity. At the same time, Egyptians blamed their government for high rates of poverty, youth unemployment, corruption, illiteracy, and deep divisions between rich and poor.

The Egyptian government, which will be formed in late 2011 or early 2012, once parliamentary and presidential elections have been held, will face considerable economic challenges. Besides bringing the high and soaring public debt under control, Egypt's new rulers must ensure that investment, economic growth, and job creation keep pace with demographic trends. This will require the creation of 700,000 new, productive, and sustainable jobs every year in the private sector to accommodate the growth of the labor force.

Because the revolution was also inspired by popular discontent with the cronyism and corruption of the Mubarak rule, the newly elected democratic government must distance itself from such practices. Egypt is not unique in this regard – corruption is rife in developing countries and common in many advanced countries. Reducing corruption requires deep changes in culture as well as economic incentives. Nonetheless, some measures can be taken immediately. Egypt's new government can create better mechanisms of control, transparency, and accountability, in order to ensure that economic opportunity does not depend mainly on political connections.

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So far, the economic policies of the transitional government have been driven by populist considerations. This is understandable in view of the fact that the government has no electoral mandate and confronts expectations that things will quickly change for the better. Nevertheless, a continuation of current policies after the elections would spell economic disaster. Large subsidies are continuing despite widespread acknowledgement inside Egypt that they need to be reduced and more tightly targeted. Food subsidies have actually been raised, in order to offset the rise in world commodity prices. An already bloated state bureaucracy of six million workers has been expanded by adding some 450,000 temporary workers to the permanent payroll.

At the same time, the popular backlash against the cronyism and corruption of the Mubarak era has prompted a wave of criminal inquiries into business deals conducted during this period; by mid-April, as many as 6,000 probes into corruption cases had been launched, according to Egypt's military leadership. The pace of new corruption investigations seems to be slowing, but there is still fear in the business community

of a witch hunt. This is enormously destabilizing. These politically motivated trials increase the perceived risk of expropriation and discourage both domestic and foreign investors. As is the case in all revolutions, popular expectations of immediate change are likely to be unfulfilled. In a poll carried out in April by the International Republican Institute (IRI), an overwhelming majority (80 percent) of Egyptians expected the financial situation of their households to improve over the course of the next year, with 32 percent thinking that it would be “much better” than at the present time. A similar surge in optimism regarding the country’s future was reported by the Gallup survey conducted in early April. If these expectations are not met, the sense of economic crisis could foster support for authoritarian populists, radical Islamist politicians, or a reversion to military rule.

This short report is the product of an exploratory trip to Egypt by the authors in mid-June 2011. Its aim is to help shape the conversation about Egypt’s economy, economic policy, and international assistance by addressing several persistent myths about the current situation.

UNLIKE MANY HIGHLY
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MYTH #1. EGYPT'S ECONOMY IS A BASKET CASE.

Although Egypt faces serious economic challenges, the situation is not nearly as dire as it is often portrayed.

Egypt has a robust and diversified market economy. Unlike the formerly planned economies of Central and Eastern Europe in the early 1990s, Egypt does not need to create markets where none existed. Before the revolution, Egypt enjoyed solid rates of economic growth, in the range of 6-7 percent between 2003 and 2009. Real GDP grew by 4.7 percent in 2009 and by 5.3 percent in 2010 according to World Bank data, notwithstanding the global financial and economic crisis; a remarkable showing. While poverty levels remained high, the available household survey data indicate that there was no widening of the income distribution, suggesting that the gains from economic growth were fairly widely distributed. Separately, economic opportunity surveys have suggested that the gap between leading and lagging regions was actually narrowing.

Prior to the revolution, the public debt-to-GDP ratio was on a declining trajectory from 104.7 percent to 80.5 percent, which nonetheless is high for a developing country. However, unlike many highly indebted nations, the vast majority of Egypt's debt is domestic; foreign debt to GDP is as low as 15 percent. Statistically, the most important sectors of the economy are manufacturing, mining, and agriculture, suggesting a rather different picture to the one painted in the popular press, which implies that the Egyptian economy is completely dependent on tourism and remittances. Foreign currency earnings are also diversified, relying on these two sectors but also on exports of agriculture and manufactured goods, as well as Suez Canal fees.

Although Egypt's economic growth prior to the revolution was impressive, unemployment officially remained in the neighborhood of 10 percent. Youth unemployment was much higher, and roughly 20 percent of the population was below the poverty line. Rapid growth helped reduce the debt burden, but fiscal deficits remained high under Mubarak, with the

former government spending extensively on subsidies and public sector employment in an ultimately fruitless attempt to maintain stability. Moreover, since the revolution of January 25, the country has been losing foreign reserves at an alarming rate. Challenges are mounting. The interim government is under enormous pressure to spend more. Public finances are on an unsustainable path.

**MYTH #2. IT IS TIME TO CONCENTRATE ON POLITICS;
ECONOMIC REFORMS HAVE TO WAIT.**

Egypt's economy is capable of resuming fairly rapid growth, but for this growth to be sustained, far-reaching economic reforms are needed. Some of these reforms cannot and should not wait. If properly explained and executed, they could also attract popular support, including among Egypt's poor.

In fact, the reforms adopted during the last years of Mubarak's rule were achieving good results. The country made considerable progress in attracting domestic and foreign investment, improving its business environment, reducing the public debt load, and generating growth. In spite of the progress achieved, the public sector remains highly inefficient, corrupt, and heavy-handed in its interventions. As a result, some 82 percent of private businesses are run informally, according to the Egyptian economist Sayed Moawad Ahmed Attia, while a 2006 Labor Market Panel Survey revealed that 61 percent of Egypt's workforce are not formally employed.

Continuation of certain reform programs of the Mubarak era, such as the privatization of state industries and reducing public sector employment, are politically impracticable at present given the interim nature of the government and the link in the public's mind between corruption and the privatization program. But popular anger at the Mubarak-era cronyism can be harnessed now to foster a more transparent and accountable public sector. Many of the reforms – such as the use of open tenders in public procurement, or better and more consistent publication of public sector-related information and data – would be almost costless and would bring about significant benefits in a short period of time.

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Furthermore, poor Egyptians can be rapidly empowered if they are given legal titles to their property and encouraged to join the legal economy. In 2004, a study by the Peruvian economist Hernando de Soto found that 92 percent of Egyptians held their real estate property without a formal title, leaving them unable to use it as collateral or to access standard contract and enforcement rules. If the costs and hassles of operating within the formal sector are reduced as well, they will prosper further.

Egypt needs a reform of the bankruptcy law, a reduction in the time and costs of opening and closing a business, lower hiring and firing costs, and reforms to protect the independence of judicial inquiries into corruption and graft. While some of these reforms might be technically demanding, and may be resisted, they would impose very little cost on public finances.

Another reform issue that Egyptians have decided to put aside for now is the extensive economic enterprises of the military, estimated to make up one third or more of the overall economy. In light of the key role of the army in removing former President Mubarak, as well as the many ongoing political disputes between protesters and the military, protest forces have decided that challenging the military's economic interests or accusing military officers of corruption would be too explosive at present.

MYTH #3. KEY FISCAL PROBLEMS – SUCH AS SUBSIDIES – CANNOT BE TACKLED ANY TIME SOON.

Even with Egypt's relatively robust growth rate, a debt-to-GDP ratio of over 80 percent and a projected budget deficit of 8.6 percent of GDP in the fiscal year 2011/2012, cannot be sustained. Without greater control of its deficit, Egypt remains vulnerable to domestic or external shocks. The government may also be tempted to print money to finance its activities, which could lead to macroeconomic instability and high inflation.

Egypt's public debt is mostly financed domestically; externally held debt constitutes only 15-20 percent of the total debt burden, according to Central Bank data. Therefore the debt has an immediate effect on the availability of loanable funds to the private sector, crowding out private investment – particularly small and medium-sized enterprises that would face difficulties accessing credit anyway.

Untargeted subsidies, particularly for fuels, constitute a large portion of the overall government spending, and the deficit problem cannot be solved without tackling these policies. The subsidies are a wasteful and inefficient method of helping poorer Egyptians. Most of their benefits are accrued to the middle classes and the well-off. A 2005 World Bank study found that a better-off Egyptian received twice the amount in subsidies as a poorer Egyptian citizen.

Reforming fuel subsidies is more urgent and politically more feasible than acting on the much smaller but highly sensitive food subsidies. The transitional government recognized this by making some small cuts to fuel subsidies in the revised budget passed in June. These changes will curb butane gas subsidies to non-residential users and extend the natural gas grid to some butane-consuming factories such as brick-making facilities. The savings from such measures will be about \$580 million (LE 3.5 billion) over the coming year.

The cuts are only a very small step in the right direction, however. In the revised 2011/2012 budget, \$16.8 billion (LE 100.5 billion) – over 20 percent of total government expenditure and 6 percent of GDP – is allocated to fuel and electricity subsidies, while \$9.6 billion (LE 57.2 billion) goes to all other subsidies and grants, of which food subsidies constitute only a small fraction, according to the Egyptian Center for Economic Studies (ECES). In the fiscal year 2010/2011, for example, the total cost of food subsidies amounted to \$2.3 billion (LE 13.5 billion).

Replacing regressive subsidies with a system of supports explicitly targeted at the poor can correct this distortion and may also prove politically appealing. Egyptian policymakers could learn from the examples of other countries – including Jordan (1991-1999), Mexico (1997) or India (1997) – which successfully replaced untargeted subsidies with alternative programs designed to alleviate poverty. Certainly such a step would be consistent with the desire for greater social justice, an important theme of the revolution. Reformers should note that different fuel subsidies impact poverty differently. The World

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Bank report found that eliminating petrol and natural-gas subsidies would have only a very small impact on the poor, increasing the incidence of poverty by 0.15 percent. In contrast, the elimination of the liquefied petroleum gas subsidy altogether would raise the incidence of poverty by 4.4 percent. The same study concluded that if subsidies are phased out gradually, and if their elimination is accompanied by a strengthened social safety net, the increase in poverty can be completely offset.

The Egyptian government should move towards identifying low-income groups and directing cash payments or subsidies to them. Various methods of proxy means-testing can be used for that purpose. Inspecting electricity consumption is the most basic test, while more detailed tests would involve information collection either through a census method or by applications taken on demand.

In the past, reformers have hesitated to reduce subsidies for fear of attacking the vested interests that benefit most from the present system: not the poor, but relatively affluent energy consumers and companies that are directly involved in the production and distribution of subsidized food and fuels. A new government with an electoral mandate may find itself in a stronger position than the transitional government to tackle these thorny issues.

MYTH #4. THE EGYPTIAN GOVERNMENT NEEDS BUDGET SUPPORT URGENTLY.

In May, the G8 pledged \$20 billion of aid to Egypt from all sources to help support a democratic transition. However, the transitional government surprised international donors in late June by rejecting some of the significant budgetary support promised, on the grounds that this assistance was no longer necessary. Expressing discomfort at taking on the large loans offered by the IMF and World Bank, the Supreme Council of the Armed Forces (SCAF) sent the cabinet back to the drawing board on the draft budget; the earlier version had included extensive social welfare spending.

The new budget reduced expenditures by 7.4 percent compared to the earlier budget, allowing the government to revise the expected deficit downward from 11 percent to 8.6 percent of GDP. In addition to cutting expenditures, the new budget relies more heavily on domestic borrowing. Besides hostility to any kind of conditionality, significant pledges of aid from Arab governments may have been a factor contributing to the abrupt reversal of the SCAF's position on the need for loans from international financial institutions.

Arab states including Saudi Arabia, Qatar, and the United Arab Emirates have made large pledges – totalling nearly \$18 billion – some more specific than others. Saudi Arabia promised \$4.5 billion in assistance, including \$500 million in cash budget support, a \$1 billion deposit in the Central Bank of Egypt, \$500 million in soft loans from the Saudi Fund for Development, a \$750 million line of credit to finance Saudi imports, and \$200 million in loans for small and medium-sized enterprises. In early July, the United Arab Emirates promised a total of \$3 billion in assistance, with half of that amount dedicated to creating opportunities for youth and the remainder to housing and other projects. Qatar has made a large – albeit unspecific – pledge of \$10 billion, \$500 million of which has been given as a cash grant. Assistance from Gulf states will contain little or none of the reform criteria likely to come with Western assistance. What is more, Gulf donors are not always as reliable as their Western counterparts in delivering on pledges.

Aid from the United States, which has historically been Egypt's largest western donor, will include \$1 billion in debt swaps (out of total debt to the United States of over \$3 billion) and Overseas Private Investment Corporation (OPIC) loans in addition to the usual annual package of \$1.3 billion in military assistance and \$250 million in economic assistance. U.S. Senators Kerry, McCain, and Lieberman have also put forward a bipartisan bill that would create an enterprise fund to support entrepreneurial ventures in the Egyptian private sector. The start-up funding would be \$80 million of reprogrammed assistance from the U.S. government, with the hope of attracting several times that amount in funds from the U.S. private sector.

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Likewise, European assistance to Egypt has been modest so far. Germany has agreed to cancel one quarter of Egypt's \$4.7 billion dollar debt, with another portion of the debt being swapped to health assistance for Ethiopia. The UK plans to provide around \$180 million in assistance to support democratic transitions in Egypt, Tunisia, and other Arab countries undergoing reform. The European Bank for Reconstruction and Development announced an intention to invest some \$3.5 billion annually in the region, while the EU allocated an additional \$1.75 billion in development aid to expand its European Neighborhood Policy (ENP), which applies to 16 countries including Egypt.

MYTH #5. THE INTERNATIONAL COMMUNITY HAS DONE ALL IT CAN DO TO HELP THE TRANSITION.

Far-reaching reforms that stimulate private sector growth and spread economic opportunity will lie at the center of a successful democratic transition in Egypt. So far, the response of the international community, particularly the United States and Europe, has been extremely modest considering the magnitude of change underway in the region and the importance of Egypt. While the relatively small offers of cash support to the Egyptian government are understandable given existing budgetary constraints, the international community should take advantage of this unique moment to promote reforms.

For the United States and Europe, the best way to do this will be to offer the prospect of increased trade. Egypt has long sought a free trade agreement with the United States, and although it has an association agreement with the EU, there are still significant barriers to the export of Egyptian produce to Europe, as well as to access by skilled workers.

In spite of the current fatigue with trade agreements in Washington, a free trade agreement with Egypt would be the best way to signal a deep and durable commitment by the United States to the success of the Egyptian transition, in tandem with a parallel, deeper, and more comprehensive agreement offered by the European Union. Further development of the US-sponsored qualifying Industrial Zones – especially in the underdeveloped areas of Upper Egypt – would also help but this is a clear second-best alternative to comprehensive trade agreements that require and help to support more far-reaching reforms within Egypt.



Future trade arrangements with Egypt should be designed to increase the access of Egyptian agriculture and labor-intensive manufactures to American and European markets and to simplify rules of origin. Such agreements should also emphasize policies that increase labor mobility within Egypt, liberalize its manufacturing and service industries, and improve market competition in the country. Comprehensive agreements would include reforms in Egypt to facilitate competition in services and increased foreign direct investment. They would also include support for trade facilitation in Egypt, including investments in the trade and transport infrastructure.

CIVIL SOCIETY, OPEN PUBLIC
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OF TRANSITION.

Donors can also help this transition through projects that develop democratic institutions, build capacity for policy making, support the private sector, and generate employment. Of course, the international community can only help Egypt in the areas where Egyptians want to act and be helped.

Here are additional examples of initiatives that Egyptians may support:

- Egyptians would benefit from stepped-up technical assistance, especially in areas that improve the business environment and strengthen Egypt's ability to attract both foreign and domestic investment. These areas include the judiciary, commercial law, bankruptcy proceedings, labor markets, and media reform.
- Because the reform of the subsidy system is so important, the international community should make a special effort to provide Egyptians with expertise from other parts of the developing world in means-testing and in the various methods used to target those most in need of social assistance.
- Private-public investments, designed to regenerate and develop areas currently occupied by urban slums, are another promising initiative with substantial long-term benefits for development, especially where the slums are located in commercially desirable areas. Loans extended to slum redevelopment projects could be a relatively safe and high-return investment, with additional social benefits accrued to poor Egyptians.
- Assistance targeted at Upper Egypt, where poverty is most serious, could have a profound impact. Funds could be used to develop the necessary infrastructure and to link local agricultural producers to both the major urban centers and international markets. Rural development in Upper Egypt would benefit greatly from a relaxation of trade restrictions imposed by the European Union on the imports of fresh fruit and vegetables from Egypt. Trade liberalization would compound the effects of development assistance on the growth of commercially viable agricultural businesses in the Upper Nile region.

Finally, civil society, open public debate, and independent journalism are all crucial for the success of the economy, as well as the political transition. While many of the comparisons between the transitions in Central and Eastern Europe in the early 1990s and Egypt in 2011 are misleading, one lesson of the 1990s remains valid: a transition towards democracy and a free market economy is unlikely to succeed without broad public support and a popular understanding of its nature and importance. This can only occur in the context of a vibrant civil society engaged in a dialogue that will allow for broader ownership of the economic and political reforms that lie ahead. The international community can and should support the transfer of expertise from other parts of the world – not only Eastern Europe, but also South America, Turkey, and India – in the development of the institutions needed to open up public debate.



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