N Gage Consulting

Public Strategy and Government Relations Specialists

Egypt General Budget 2015-2016

July, 2015

The issuance of the state budget is one of the most widely anticipated events during the year as it provides insights on the government's economic plans and directions. In light of the President's approval of the 2015/2016 Fiscal Year's (FY2016) budget on the 2nd of July, 2015, this report provides a budget performance review of the previous fiscal year, and provides brief analysis on the current FY 2015/2016 budget.

Contents

Egypt's Fiscal Performance in FY2015

The Government of Egypt (GoE) took very positive steps towards reform in FY2014/2015. Several critical fiscal reforms were enacted, that have long been considered taboo. The fiscal reforms adopted with last year's budget include:

Expenditure Side	Revenue Side
Raising fuel prices	Levying a 5% "rich tax"
Raising electricity prices, with a five-year liberalization plan	Levying a capital and dividends gains
Setting a maximum wage on the public sector	Activating the real estate tax

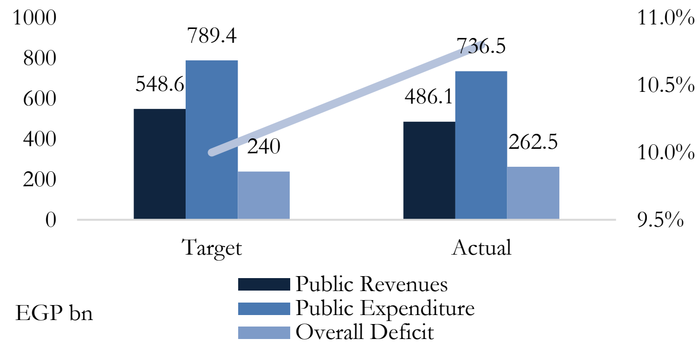
The reforms that have been adopted and highlighted above, in addition to pledges of further anticipated and pledged reform – such as the long awaited VAT law – have boosted the confidence of the economy since their announcement. Such reforms helped reposition Egypt on an enhanced fiscal trajectory, achieving much better results than the previous fiscal year. The current budget is expected to close at 10.8% of the GDP, compared to 12.8% in FY2014/2015

However, the positive impact of the reforms was diminished due to several factors. First, the hesitant fiscal policy-making in FY2014/2015-which resulted in the cancelation of the capital gains tax and the "rich tax" and the postponement of the VAT-has negatively affected confidence in the economy. The capital gains tax was postponed for two years after causing a stir among traders and brokers. Additionally, the GoE had announced the cancelation of the "rich tax", as well as capping the income tax at 22.5%; yet, the official decree for this amendment had not been issued until July. This inconsistent and opaque policy-making was not in line with the GoE's pledge to adopt clear, consistent and prudent policies, which has negatively affected investors' sentiment.

Second, the performance of some of the newly levied taxes (capital gains and real estate taxes), were much lower than the forecasts. It was forecasted that the real estate tax would collect EGP 3.5bn of revenues; however, the actual toll will be less than EGP 900mn. Even before its postponement, the capital gains collected revenues less than EGP 200mn, while it was expected that it would collect EGP 3bn for FY2014/2015. This contributed to the lower revenue level achieved.

The actual fiscal performance in FY2014/2015 is expected to be below early targets[1]. At the beginning of the year, the GoE targeted to collect EGP 548.6bn of revenues, while the actual toll is expected to be around 11.4% less, at EGP 486.1bn. This is mainly due to the lower-than-expected tax receipts, expected to reach EGP 317.8bn, versus the initial target of EGP 364.8bn. **This can be attributed to the following reasons**:

FY2015 Budget



*Expected

Source: 2014/2015 and 2015/2016 Financial Statements, Ministry of

- The weak performance of the real estate tax which is expected to collect EGP 900mn versus the initial target of EGP 3.69bn.
- The weak performance of the capital gains and dividends tax which is expected to collect around EGP 300mn versus the initial target of EGP 3.2bn. Delaying the capital gains tax for two years exacerbated the situation.
- Postponing the shift to the VAT to FY2015/2016,which was expected to collect around EGP 25bn of additional sales tax revenues for the full year and EGP 12.5bn for the second half of FY2014/2015.
- The weak performance of the taxes on "non-trade free professional activities" which is expected to collect around EGP 0.5bn versus the initial target of EGP 2.95bn. This captures the state's limited visibility and control over the free professions.
- The lower-than-anticipated taxes on the sovereign entities' profits (Central Bank, Suez Canal and Egyptian Petroleum Corporation) which are expected to reach EGP 53.9bn versus the initial target of EGP 77.7bn.

It is noteworthy to mention that stronger collections from taxes on salaries (by around EGP 5bn), and industries and services (by around EGP 200mn) capture the impact of the enhanced economic activity.

Public expenditure is expected to be below the targeted levels as well; by around 6.7%.Public expenditure is expected to reach EGP 736.5bn versus the initial target of EGP 789.4. **The main factors behind this are as follows:**

- The lower **public wage bill**, which is expected to reach EGP 200.7bn versus the initial estimate of EGP 207.2bn.
- The lower **purchases of goods and services** which are expected to reach EGP 30.5bn versus the initial target of EGP 33bn.
- The lower **subsidy bill** which is expected to reach around EGP 200bn versus the initial target of EGP 233.8bn. This captures the impact of the fall in the global oil prices which saved the country around EGP 30bn.

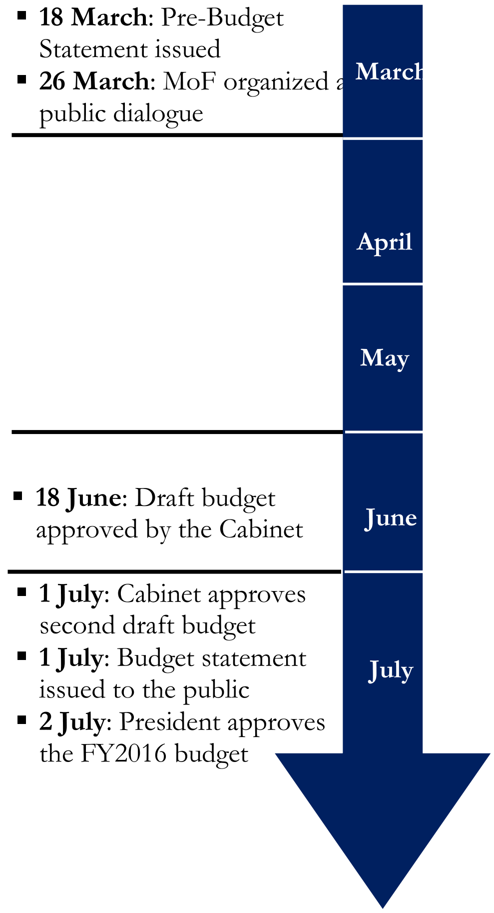
The overall deficit is expected to reach EGP 262.5bn (10.8% of the GDP) versus the initial target of EGP 240bn (10% of the GDP). On the Other hand, the World Bank estimates the deficit in FY2014/2015 to reach 11.5% of the GDP[2] while the IMF expects it to be around 11%[3].

[1] The budget officially closes in November or December
[2] Egypt Economic Monitor Spring 2015, The World Bank
[3] Article IV Consultation 2014 – Staff Report, IMF

FY2016's Budget

A Last Minute Budget

The FY2015/2016 budget is truly a last-minute budget. The budget's first draft was approved by the cabinet on the 18th of June, a mere 15 days before the start of the new fiscal year. The first draft was then rejected by the President for having a deficit of 9.9% of the GDP, which was considered too high. The cabinet approved the second amended version on the 1st of July, with the President approving it on the 2nd day into the new fiscal year. It was not issued to the public except on the first day of the new fiscal year.



The lack of transparency that surrounded the budget brought the GoE under heavy criticism from several political parties, economic experts and civil society organizations. Al Wafd, Egyptian Social Democratic Party, Reform and Development Party, "Masr Al Kaweya" and the Egyptian Center for Social and Economic Rights have all voiced their concern over the way the budget was issued and the absence of a proper societal dialogue. Some have even accused the budget of being unconstitutional, with reference to Article 124 in the Constitution which stipulates that the budget has to be presented to the Parliament 90 days before the start of the new fiscal year. "International Budget Partnership" has also criticized the late issuance of the budget's financial statement which eliminates the possibility of holding a proper societal dialogue. It is of note to mention that the "International Budget Partnership" praised the GoE when a "Pre-Budget statement" was issued back in March.

Macroeconomic Targets

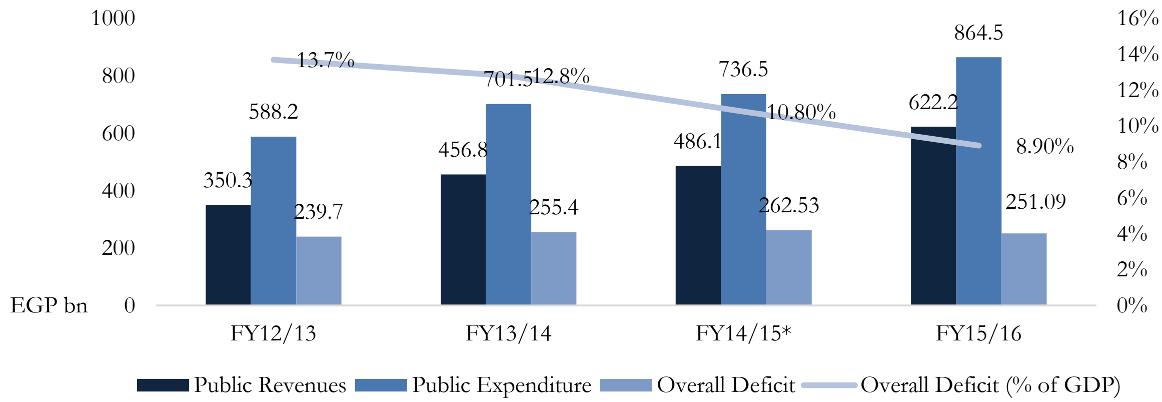
The GoE has prepared the new budget in line with short and medium-term economic plans. The FY2015/2016 budget highlights the following macroeconomic targets:

	FY2014/2015*	FY2015/2016	FY2018/2019
Real GDP Growth	4.2%	5%	7%
Budget Deficit (as a % of GDP)	10.8%	8.9	8-8.5%
Public Debt (as a % of GDP)	93.8%	90-91%	80-85%
Unemployment	12.8%	11.5-12%	Below 10%
Inflation	12-13%	10-11%	7-8%

*Expected

Source: Ministry of Finance

General Overview



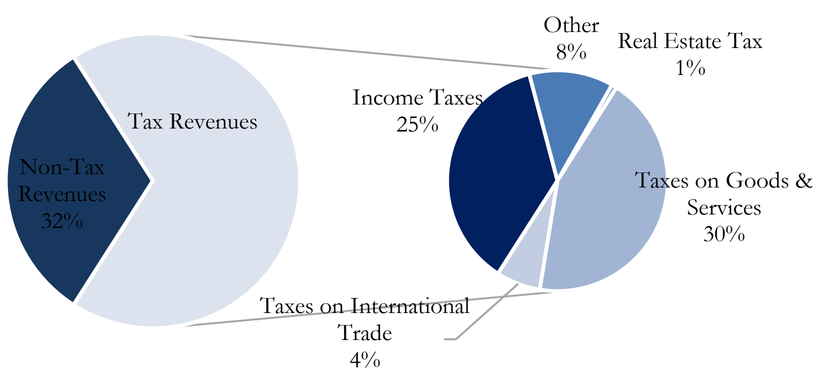
*Expected

Source: 2014/2015 and 2015/2016 Financial Statements, Ministry of Finance

The FY2016 budget registers very ambitious targets. The GoE targets to collect EGP 622.2bn of revenues, 28% more than the expected level in FY2015 and representing 22.1% of the GDP. Public expenditure is estimated to reach EGP 864.5bn, 17.4% more than FY2015 and representing 30.6% of the GDP. Deficit is expected to decrease both in absolute terms and as a percentage of GDP. Overall budget deficit is expected to stand at EGP 251.09bn, as compared to EGP 262.53bn in FY2015. This will represent 8.9% of the GDP, as compared to 10.8% in FY2014/2015. The World Bank estimates the budget deficit to reach more than 10% in FY2016[4].

Public Revenues

Public Revenues FY2016



Source: 2015/2016 Financial Statements, Ministry of Finance

The GoE targets to collect EGP 422.3bn of tax revenues, representing 68% of total revenues and 15% of the GDP. Tax revenues in FY2015/2016 represent a 33% increase than the expected toll in FY2014/2015.

[4] Egypt Economic Monitor Spring 2015, The World Bank

Main tax components are as follows:

	FY2014/2015*	FY2015/2016	% Change
Taxes on goods and services	EGP 118.5bn	EGP 184bn	55.2%
Income taxes	EGP 136.5bn	EGP 158.7bn	16.3%
Taxes on international trade	EGP 21.5bn	EGP 27.4bn	27.4%
Real estate tax	EGP 900mn	EGP 3.2bn	255.6%

The GoE bases the significant rise in tax revenues on the expected pickup in economic condition, the continuation of the second phase of reforms and the adoption of more measures to counter tax evasion. Most important tax reforms expected in FY2015/2016 are as follows:

- Shift from the General Sales Tax (GST) to the **VAT system**, which is expected to yield extra revenues worth 1% of the GDP (around EGP 32bn).
- Capping the **income tax at 22.5%** instead of 25%, while raising the rate for new projects in Special and Free Economic Zones from 10% to 22.5%.
- Upgrading the capabilities of the **Tax Authority** through the continued automation of different functions, the development of comprehensive and inter-linked databases and the training of the Authority's workforce.
- Preparation of a new **Customs Law** that would streamline customs procedures and set tougher punishments for customs evasion.

As for non-tax revenues, the GoE estimates that they would reach EGP 200bn in FY2015/2016, 19% more than in FY2014/2015, even though the budget only accounts for EGP 2.2bn of grants**. The growth in non-tax revenues comes on the basis of:**

- The full implementation of the **Mining Law** which is expected to collect revenues from exploration and operation licenses.
- Accepting financial settlements for the **violations on agricultural lands**.
- Directing a larger share of the **Suez Canal, Central Bank, public enterprises and other authorities' profits** to the state budget. Profits worth EGP 102bn are expected to be directed to the state budget in FY2016, representing 52% of the total non-tax revenues.

While the large growth in public revenues is an ambitious and respectable target, it is not really clear how the GoE will manage to achieve it, given the obvious slowdown in fiscal consolidation. In FY2014/2015, the GoE failed to reach the tax revenue target of EGP 364.3bn, only to increase the target even higher to EGP 422.3bn. This is especially unfathomable given the 22.5% income tax cap and the delay of the capital gains tax, which will definitely have an impact on the tax toll. The underwhelming performance of the real estate tax in FY2014/2015 (expected to collect less than EGP 900mn versus a target of EGP 3.6bn) raises doubts in the effectiveness of the state's collection mechanisms and hence its ability to meet the EGP 3.2bn target. The GoE seems to count on the VAT for the biggest impact. However, even if the GoE adopts the VAT for the full year (which is unlikely), achieving the EGP 32bn remains a very tough task in the first year of implementation. In addition, the GoE seems to count on the financial settlements for violations on agricultural lands as well. Yet, no details have been announced on the expected revenues or even the state's policy in settling with such offenses. If the GoE wants to have any chance of achieving the revenue target, swift actions need to be taken, especially the shift to the VAT and the automation of the customs and tax offices.

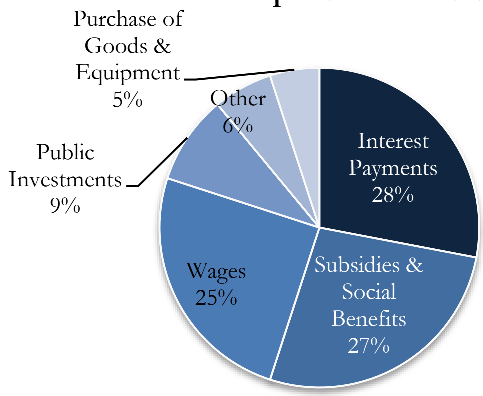
Public Expenditure

Public expenditure is estimated to increase by 17.4% to reach EGP 864.5bn on the back of the increase across all of the main expenditure components. Interest payments, subsidies and public wages still account for more than 80% of total expenditure. The FY2015/2016 shows a slowdown in fiscal consolidation and reform, as compared to last year. The GoE opted to postpone any reforms in the fuel subsidy system by not increasing fuel prices and delaying the adoption of the fuel card system. Additionally, the GoE decided not to raise the electricity prices on the first three consumption segments, as a social measure. At the same time, the budget registers an increase in spending on social services and programs of 16.5%. Below are the main features of public expenditure in FY2015/2016:

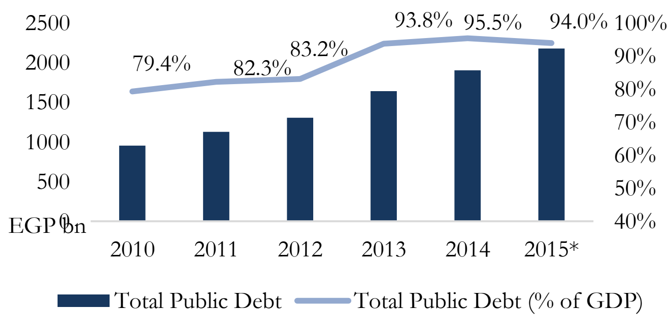
Interest Payments

Interest payments have grown significantly in recent years as the GoE increasingly resorted to domestic borrowing to finance the widened deficit. Total public debt increase from EGP 957.5bn (79.4% of the GDP) in 2010 to EGP 2.2tn (94% of the GDP) as of March 2015, representing a 130% increase. In turn, total interest payments increased by 25.1% to reach 244bn in FY2014/2015 budget, representing 28% of total expenditure and 8.7% of the GDP.

Public Expenditure FY2016

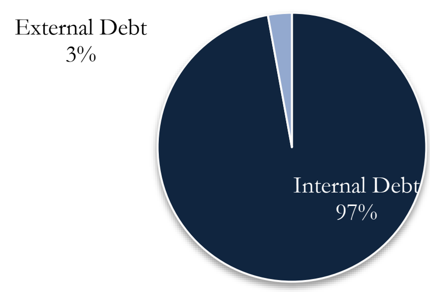


Source: 2015/2016 Financial Statement, Ministry of Finance



Source: Monthly Bulletin May 2015, Ministry of Finance

Interest Payments due FY2016



Source: 2015/2016 Financial Statement, Ministry of Finance

The GoE's tendency to cover the deficit through domestic borrowing is obvious in the structure of the interest payments due. Interest payments on internal debt accounts for 97% of total interest payments due.

Subsidies and Social Benefits

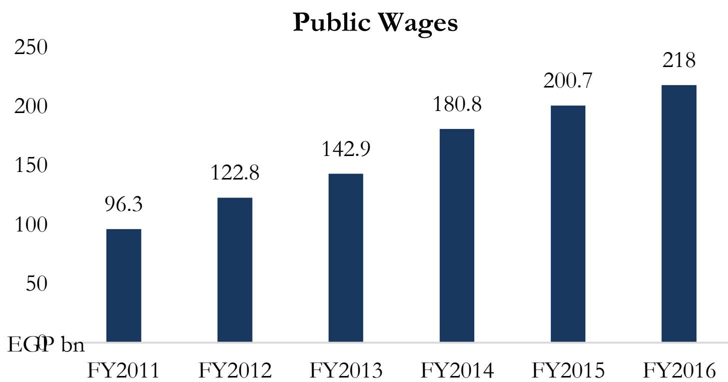
The FY2015/2016 budget targets EGP 231bn to be spent on subsidies and social benefits, as compared to EGP 200bn in FY2014/2015. Petroleum subsidies decreased to EGP 61.7bn from EGP 70.2bn in FY2014/2015[5]. Commodity subsidies increased to EGP 37.8bn, by 19.6%, as the GoE aims to scale the bread subsidy mechanism nationally. It is expected that 3mn more Egyptian will benefit from the new mechanism in FY2015/2016, to bring the total percentage of beneficiaries to 70% of the population. Additionally the GoE is expanding the cash transfer program through the newly launched "Takafol" and "Karama" programs. The most important social programs are highlighted below:

	FY2015*	FY2016	% Change
Health programs	EGP 42.4bn	EGP 49.2bn	15%
Education programs	EGP 104.3bn	EGP 109.7bn	5.2%
Commodity subsidies	EGP 31.6bn	EGP 37.8bn	19.6%
Electricity subsidies	EGP 28.7mn	EGP 31.1bn	8.1%
Petroleum subsidies	EGP 70.2bn	EGP 61.7bn	-12.1%
Cash transfer programs	EGP 6.6bn	EGP 11.4bn	71.2%
Housing programs	EGP 21.9bn	EGP 25.3bn	15.6%
Pensions and Social Insurance	EGP 32.2bn	EGP 52.5	58%

Source: 2015/2016 Financial Statement, Ministry of Finance

Public Wages

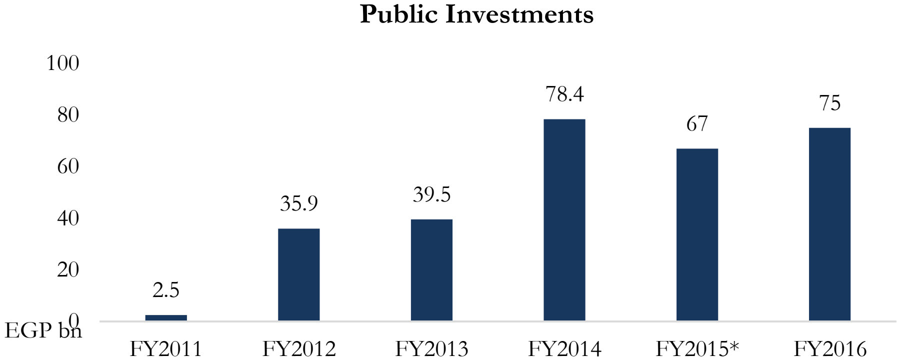
Egypt's inflated wage bill has always been a huge burden on the state's budget, especially given the extremely low productivity of the public sector. In FY2015/2016, EGP 218bn are allocated to public wages, representing an 8.6% increase. In an effort to control this huge burden, the GoE froze the bonuses of all public workers. The persistence of the increase came due to the implementation of the final phase of the Doctors' Cadre Law. The GoE counts on Law no. 18/2015 or the Public Service Law to play a leading role in reforming the public sector.



Source: 2015/2016 Financial Statement, Ministry of Finance

5 The budget forecasts Brent Crude to sell at USD 75/barrel in 2015 and USD 70.1/barrel in 2016.

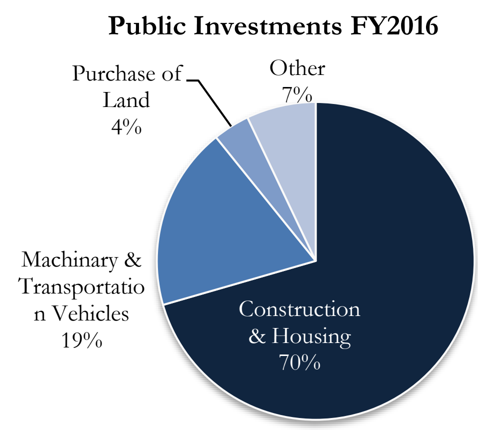
Public Investments



Source: 2015/2016 Financial Statement, Ministry of Finance

Stimulating investments has been one of the current government's most important policies. Public investments in the new budget are expected to reach EGP 75.5bn (2.6% of the GDP), EGP 55bn of which are financed from the state's resources, while the rest through grants and self-financing. The GoE prioritizes investments to create jobs and upscale the nation's infrastructure base.

While the detailed distribution of public investments has not been issued, an analysis of the uses of public investments is in line with the GoE's policy of infrastructure spending. Around 70% will be dedicated to the construction of roads, utilities, housing and non-housing establishments. Then 19% will be used to purchase new machinery and transportation vehicles. This makes the sectors of construction, housing and utilities and transportation account for most of the public investments. The GoE also aims to pull for more investments through marketing large and mega projects (Suez Canal, Golden Triangle, energy projects, etc...) via Public Private Partnership (PPP) or Build, Operate and Transfer Agreements (BOT), given the state's limited financial capabilities.



Source: 2015/2016 Financial Statement, Ministry of Finance

Other Expenditure

This component entails mainly expenditure on the military, national security, judiciary and the constitutional court. Other expenditure is expected to reach EGP 54.8bn, as opposed to EGP 49.1bn in FY2014/2015. While the spending increase is not in line with the state of war Egypt is passing through, most military spending is financed through foreign grants and self-finance by the Egyptian Armed Forces.

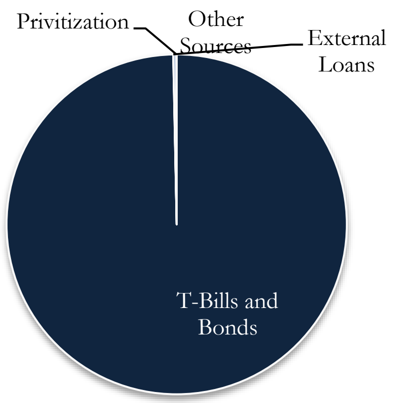
Overall Deficit and Finance Gap

It is expected that the finance gap in FY2015/2016 will reach EGP 509bn. The finance gap goes beyond the budget's overall deficit, to include the payments due for internal and external debt installments (excluding interest payments which are factored in the budget).The gap is broken down as follows:

- Overall budget deficit: EGP 251bn
- Debt installments: EGP 257.9bn

The main source to cover the financing gap is domestic borrowing, where the GoE sells medium and long-term T-bills through the primary bank market. The GoE plans to cover EGP 507.8bn through the sales of T-bills and bonds, representing almost 100% of the finance gap. External loans are expected to cover EGP 101mn, privatization to cover EGP 250bn and other sources of finance to cover EGP 1.3bn.

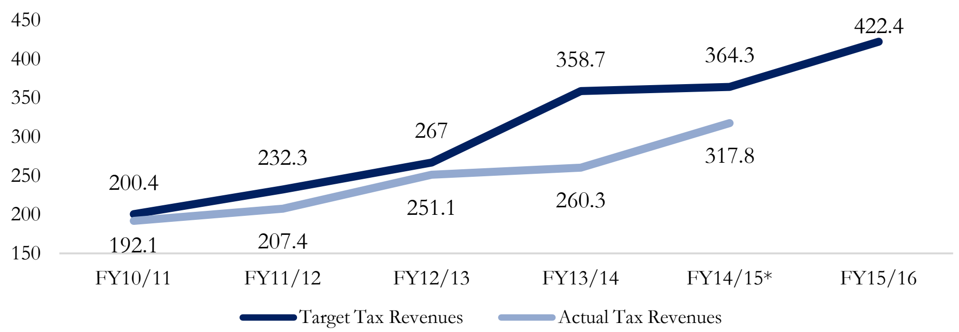
Public Expenditure FY2015/2016



Source: Ministry of Finance

Concluding Remarks

- Reform momentum in FY2014/2015 resulted in an enhanced fiscal performance as compared to FY2013/2014. Yet, actual figures signal a performance below earlier expectations.
- The FY2015/2016 budget registers very ambitious targets, which are in line with Egypt's short and medium-term economic plans.
- The FY2015/2016 budget witnesses a slowdown in fiscal consolidation measures, relative to FY2014/2015. Fewer clear measures are planned to increase revenues, with almost no measures to restructure expenditure.
- The target tax toll of EGP 422.4bn is a very ambitious target, given that it is 16.4% higher than the target the GoE could not achieve in FY2014/2015. Two main factors raise considerable doubt in the GoE's ability to meet the tax revenues target in FY2015/2016:
    - The absence of clear measures that can increase the tax toll in the short run, other than the VAT.
    - Egypt's history of underwhelming tax performance (as shown in the graph).



- The persistence of the rise in all expenditure components (public wages, interest payments, public investments, purchases of goods and services and subsidies and social benefits) raises doubts that the GoE will manage to achieve the target deficit level of 8.9% of the GDP. The World Bank estimates the deficit to stand at more than 10% in FY2015/2016.
- Interest payments are forecasted to reach EGP 244bn in FY2015/2016, 25% more than in FY2014/2015. This comes as a result of the Egypt's widened deficit in recent years.
- Public wages rose by more than 5% in FY2015/2016, as the GoE struggles to effectively reform this sensitive component. All increases in public wages and bonuses have been frozen in FY2015/2016. It is expected that more reform will take place to restructure public wages as the Public Service Law will come into effect.
- Social spending continues to rise by 15.5%, as the GoE strives to meet the constitutional obligations.
- Public investments are expected to increase by 12%, as the GoE prioritizes infrastructure investments to stimulate the economy. Transportation and housing, construction and utilities are expected to be the top destinations for public investments.
- The Finance gap in FY2015/2016 will reach EGP 509bn, almost all of which will be financed through domestic borrowing. This is expected to reduce the already-low loans to deposits ratio of 44%, resulting in more crowding-out of the private sector from the banking system.
- If the GoE wants to have any chance in reaching the targets, the swift adoption of the planned reforms is required.