N Gage Consulting
Public Strategy and Government Relations Specialists

Regulatory Reform for Social and Economic Justice

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Introduction

With the approval of the latest fiscal budget for the year 2014/2015, the new government has proposed a number of regulatory reform measures that intend to provide a lifeline for the ailing economy and cure the dangerous budget deficit. The undertaken reforms, namely, the fuel subsidy reform, income tax reforms, tobacco and liquor tax increase and the maximum wage to help bring the deficit down. Moreover, the competition law has been amended and a committee for legislative reform has been formed to in order to solve Egypt's chronic problem of cumbersome regulations.

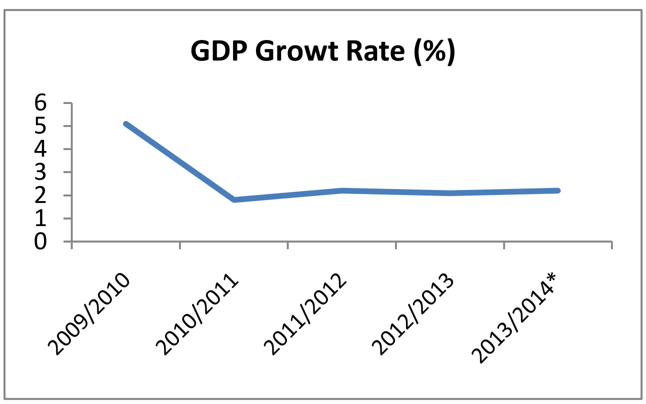
All the decisions that have been taken point out that the government is no longer afraid of taking bold decisions that are considered necessary to restore long term confidence in the Egyptian economy, which has been reflected in the EGP 3.3 Billion market capitalization increase in the past few days.

These measures should be considered as the first "reform wave" of many more waves to come in the near future, such as the VAT law that is expected to be finalized by the end of 2014 or the beginning of 2015.

However, some of these measures, while positive on the long-term, will have short-term costs. This is the case especially for the lower strata of the economy. Therefore, the government must make sure to adopt the required policies to cushion the effect of the reforms. This report examines the reforms mentioned and analyzes its short-term effects and possible impact.

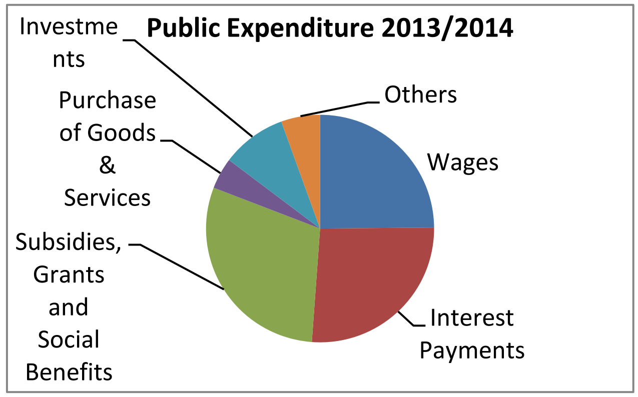
Overview of the State of the Economy

After 3 years of turmoil, the state of the Egyptian economy in Egypt has become unsustainable. The economy has been plagued by weak growth over the past three years, with an expected growth rate in 2013/2014 of 2.2%. The weak growth rate is explained by the poor performance of most economic sectors, especially the tourism and extractive industries sectors, both recording negative growth rates of -29.6% and -3.8% respectively in the first half of 2013/2014. The weak GDP growth reflects the weak investment rate which is expected to reach 13.1% of the GDP in 2013/2014 down from 22.4% in 2007/2008. Foreign Direct Investment (FDIs) went down to $3 billion in 2012/2013 from $ 8.1 billion in 2008/2009. Lower FDIs and the disastrous performance of the tourism sector dried up Egypt's net international reserves which stood at $17.4 billion down from more than $ 35 billion in 2009/2010. The poor performance of the economy affected its ability to create jobs and absorb new entrants to the labor market causing the unemployment rate to reach 13.4% in the first quarter of 2013/2014.

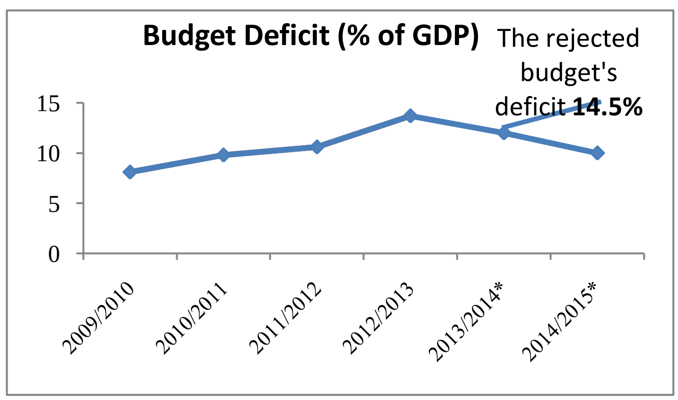


The budget deficit is expected to reach 12% (would have been more than 15% if not for the grants and loans mainly from the gulf) for 2013/2014. Debt levels are alarming as well with the total domestic public debt standing at EGP 1.7 trillion (85% of the GDP) and total external debt at $45.3 billion (15.4% of the GDP).

Egypt has been running one of the most rigid budgets for years with most of it (around 80%) going to wages, subsidies and debt servicing, leaving scraps for spending on upgrading social services like education and health. The dangerously high deficit and debt levels present a serious risk to the long-term welfare of the country.



It is noteworthy to mention, that the first draft of the 2014/2015 budget was reject by the President. The rejected budget registered a deficit of 14.5%, which is considered way above the safe rates. In addition, the total public debt would have been in excess of EGP 2.1 trillion.



Fiscal Reforms

Oil and Gas Prices Decrees

Prime Ministry Decrees number 1159-1162, July 3rd, 2014

Prime Ministry Decree number 1159, 3rd of July, 2014 – Heavy Fuel Oil Prices

The decree dictates that the standard Diesel prices are as follows, enforceable on the 5th of July, 2014:

1) **1,400 EGP** for each ton delivered as per the authorization and approval of the Minister of Industry, Trade and Small and Medium Enterprises, to the **Food Industry**
   2,300 EGP for each ton delivered to the **Energy Industry** for electricity generation purposes to all publicly owned entities as well as privately owned entities that directly supply to the grid.
2) **2,250 EGP**per ton delivered to distribution hubs supplying the Cement Industry
3) **1,950 EGP** per ton delivered to distribution hubs for general consumption and purposes.

Prime Ministry Decree number 1160, 3rd of July, 2014 – Petrol Fuel Prices

The decree dictates the new Petrol Fuel prices as follows:

1) 80 Octane: **EGP 1.60** per liter, tax inclusive
2) 92 Octane: **EGP 2.60** per liter, tax inclusive
3) 95 Octane: **EGP 6.25** per liter, tax inclusive
4) Kerosene: **EGP 1.80** per liter, tax inclusive
5) Diesel: **EGP 1.80** per liter, tax inclusive

Prime Ministry Decree number 1161, 3rd of July, 2014 – Natural Gas as car fuel Price

The decree dictates that the new price of natural gas used as car fuel is **EGP 1.10** per cubic meter, tax inclusive.

Prime Ministry Decree number 1162, 3rd of July, 2014 – Natural Gas for Industrial consumption

The decree dictates that the new prices for natural gas used of industrial consumption are as follows:

1) **$3 (Three US Dollars)** for each 1 million British Thermal Units (BTU) of natural gas supplied for **electricity generation purposes** to all public and private entities.
2) **$4.5 (Four and a half US Dollars)** for each 1 million British Thermal Units (BTU) or equivalent of natural gas supplied for **the petrochemical and fertilizer industries** (Public or private).
3) **$8 (Eight US Dollars)** for each 1 million BTU supplied to the **Cement Industry**
4) **$7 (Seven US Dollars)** for each 1 million BTU supplied to the **Steel, Aluminum, copper, ceramic and porcelain, and glass panel** industries.
5) **$5 (Five US Dollars)** for each 1 million BTU supplied to the **Ginning and Textile, Pharmaceutical, engineering, and other industries.**
6) **14.1 Piasters** per cubic meter supplied to **Local bakeries**

The prices specified for residential and commercial consumption are based on the consumption level and are priced as follows:

1) 40 piasters per cubic meter up to 25 cubic meters
2) 1 EGP per cubic meter for every cubic meter consumed between 25 and 50 cubic meters
3) 1.50 EGP per cubic meter above 50 cubic meters

Analysis

The biggest thorn in the back of Egyptian policymakers for years has been the subsidy bill; the energy subsidy bill in particular. For so long, policy makers have been avoiding dealing with this hypersensitive dilemma in fear of arousing public outrage. In recent years, the fuel subsidy bill has witnessed a sharp increase due to surges in global fuel prices as well as the ever-growing domestic demand. The situation became unsustainable, given the turmoil that has engulfed the country and its negative repercussions on the economy. Numbers translate the picture better, that is, the petroleum subsidy bill rose from EGP 60.25 billion in 2007/2008 to about EGP 100 billion in 2013/2014. In 2013/2014, the total subsidy bill represented more 30% of the budget (petroleum subsidies constituted more than half of the bill).

For all this, there was a unanimous agreement that the subsidy bill needed to be curtailed gradually. Most economists welcomed the step as a bold and essential move to help remedy the dangerously high deficit. Furthermore, reducing the subsidy bill will free some funds, EGP 51 billion according to Prime Minister Ibrahim Mehleb, to be better spent on more effective safety nets, infrastructure development, education or or health. Also, such a move is expected to attract more investments to the petroleum sector.

However, some argued that the decision hit the poor the most and that it took place when there are no sufficient safety nets to cushion the effect. Also, some felt that the government needed to set proper prices monitoring mechanisms before the move, especially that it has been notoriously ineffective in that matter recently. After the decision, prices of food, transport, building materials and several others witnessed an increase, with others expected to rise as well, such as fertilizers. Several sectors have been affected by the decision, namely, building materials, communication, agriculture and fishing, housing and construction, among others. Another criticism for the decision was the fact that the government did not raise such a sensitive topic in a community dialogue, especially, when there is no parliament.

The government has been taking several measures in attempt to monitor and regulate the prices. For example, cheaper food is offered at government cooperatives and Carrefour, the Ministry of Interior is trying to monitor the prices of microbuses and a calculated increase was instilled in the Taxis' meters. Additionally, the minimum wage law has been adopted, It is unclear if those measures will be effective.

Furthermore, the Monetary Policy Committee at the Central Bank decided to raise key interest rates by 100 points to help curb inflation; therefore, the overnight deposit rate became 9.25% and the overnight lending rate 10.25%. By this the Central Bank set its priorities, with keeping inflation and exchange rates in check being on top. The move primarily awards depositors more on their savings to withhold the expected increase in prices and helps put taps on inflation expectations. The effectiveness of the move in controlling inflation is debatable, especially since the increase in prices is caused by an actual increase in the cost of factors of production. Such a move will also increase the amount of debt services the country has to pay.

New Income Tax Law, number 53 for the Year 2014

The new law, number 53 for 2014, dictated several amendments to the Income Tax Law, the most important of which are:

- An annual tax will be levied on revenues incurred abroad by individuals and companies based in Egypt.
- 5% annual tax will be levied, for the coming three years starting 2014, on individuals and companies earning more than EGP 1 million a year.
  The law also stipulated that the Minister of Finance will decide on development projects in education, health or infrastructure that companies may fund to get some sort of relief from this tax.
- A 10% tax will be levied on capital gains and stock dividend.

Presidential Decree for issuing the law 58 for the year 2014[1]

Annulment of law 102 for the year 2012

The Presidential Decree number 58 for the year 2014 has officially cancelled the decree for the law 102 for the year 2012.

Increase of Tobacco taxes

The Presidential Decree number 58 for the year 2014 has dictated a tiered tax increase on cigarettes as follows:

1) A **50 piaster** tax increase on cigarettes sold under EGP 9 per box
2) A **EGP 1** tax increase on cigarettes sold between EGP 9 and EGP 15.
3) A **EGP 1.50** tax increase on cigarettes sold above EGP 15

Increase of Alcoholic Beer taxes

The Presidential Decree number 58 for the year 2014 has dictated a minimum of EGP 400 for every hectoliter of alcoholic beer. This tax should be implemented on imported as well as locally produced beers.

[1] Reference: Mass Live

Increase of Wine taxes

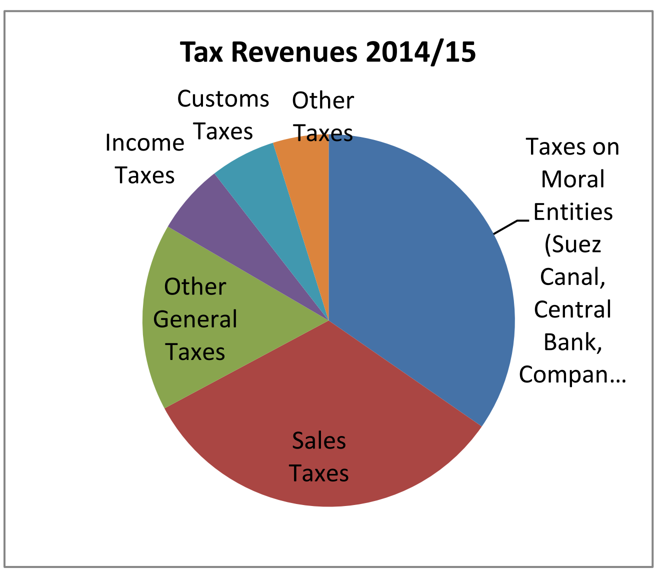
The Presidential Decree number 58 for the year 2014 has dictated a minimum of EGP 15 for every liquid liter of wine. This tax should be implemented on imported as well as locally produced beers.

This decree on Tobacco, Beer and Wine taxes increases a flat tax on local and imported cigarettes to between 25 and 40 cents per pack, depending on the brand. It doubles an already existing tax on beer, from 100% to 200%, and increases the tax on local and imported wines to 150%.

Statistics estimate the number of people smoking in Egypt to be between 17% and 21% of the adult population. The World Health Organization in 2006 has estimated Egypt's annual alcohol consumption at around 0.2 liters per person, excluding the tourism sector that Egypt caters. Until now, this decree has not caused any mass protests or an outpour of discontent.

Tax Reforms Analysis

Egypt's expected tax revenues in the FY 2013/2014 are approximately EGP 290 billion representing 14.1% of the GDP, while in the 2014/2015 budget it is planned to generate approximately EGP 365 billion from taxes representing %15.2 of the GDP. Egypt's revenues from taxes as a percentage of the GDP is still too low when compared to the international figures. That is to say, the average tax revenue as a percentage of the GDP for low-income countries is 23%, 28% for emerging economies and around 36% for developed countries. The government had to either widen the tax base or impose new taxes (such as the ones mentioned above). According to the head of the Egyptian Tax Authority, Mostafa Abdel Kader, the new taxes will raise up to EGP 10 billion.



It was reported that the Federation of Egyptian Chambers of Commerce objected to the capital gains tax before its issuance and presented a memo to then President Adly Mansour to postpone it. Also, the stock market reacted mildly to the capital gains tax suffering some losses right before the implementation of the law before rebounding again.
Finance Minister, Hany Demian, stated that the amendments to the tax law will help combat tax evasion which is identified as a major impediment in Egypt. In addition, the "rich tax" will encourage the private sector to spend more on CSR to play an active and pivotal role in the development of the nation.

It is widely expected that new tax reforms would follow, namely, switching to the VAT system and imposing the real estate tax.

However, the reforms thus far have neglected completely what is inhibiting Egypt from recording optimal tax revenues, the huge and untaxed informal sector. Egypt's informal sector is estimated to generate revenues equaling around 40% of the GDP and employ around 5 million workers[2]. All this economic activities go untaxed, depriving the state of huge revenues. Egypt needs to widen the tax base in order to significantly increase its tax proceeds.

This will only be done through formalization of the huge informal sector. For this to happen, members of the informal sector need to clearly see the benefits of formalization, such as obtaining social security and access to credit.

[2] "Making the Case for Formalization in Egypt", Egyptian Center for Economic Studies

Maximum Wage Law[3]

President Abdel Fattah El Sisi has issued a decree on the 3rd of July, for the issuance of a maximum wage law that limits the wage of any public worker, including public banks and excluding public workers abroad, to a maximum of EGP 42,000 per month, which is 35 times the minimum wage of EGP 1,200.

The law will be applied to workers at government institutions, including the defense and interior ministries, the Central Bank of Egypt, all other publicbanks, the Suez Canal Authority and the Egyptian Stock Market. Only diplomatic missions are exempt, because the law took into consideration the varying cost of living rates around the world.

The presidency said in a statement that the decree was based on Article 27 of the Constitution, which states that "the economic system is socially obliged to equal opportunities, fair distribution of development returns, decreasing the differences between wages, the commitment to a minimum wage that grants good living standards, and a maximum wage to all state actors according to the law".

Hisham Genena, Chairman of the Central Auditing Agency, provided President Abdel Fattah Al Sissi a report mentioning that 7 entities refused to provide data about the application of the maximum wage law.These entities include State Litigation Authority, State Council and the Courts ofCassationandAppeal.

Impact of the Fiscal Reforms

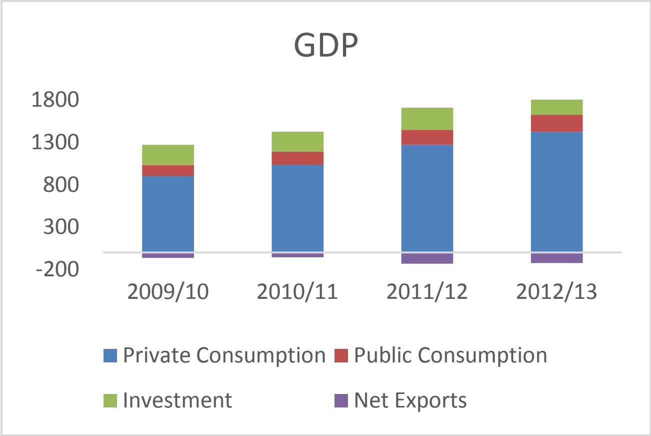
As mentioned above, Egypt's debt levels and budget deficit have reached dangerous levels rendering the country vulnerable to interest rate shocks and reduces its long-term growth potential. Therefore, the government went with austerity and fiscal consolidation[4] by reducing, or at least reforming, public expenditure and raising revenues through new taxes.

To elaborate more, public expenditure in 2014/2015 budget stood at EGP 789 billion or 32.8% of the GDP which is less than the 2013/2014 budget where public expenditure stood at 36.2% of the GDP. Moreover, government revenues in the new budget were EGP 549 billion, representing a slight increase of 8.3% than the 2013/2014 budget. On the other hand, public expenditure in the new budget is valued at EGP 789 billion representing a 7.1% increase. However, as a percentage of the GDP, public expenditure registers a decrease from 37% to 32%. The changes in the budget were mainly attributed to the above mentioned reforms. Such reforms, especially the increase in fuel prices, will definitely have a positive impact on the economy on the long term, removing some of the chronic distortions, improving the economy's potential output and enhancing its fiscal future. Fitch, the credit rating agency, and the IMF have praised the reforms undertaken by Egypt, especially, the fuel subsidy reforms. This prompts the expectations that if Egypt continued on the same path, an upgrade in its credit profile and the attainment of the much-sought-for IMF loan are inevitable.

However, they will also have some short term costs. In general, austerity has negative short-term effects on an economy. Fiscal consolidation was found to increase unemployment, and reduce private consumption and investments[5].

It is expected that the increase in fuel prices will cause an increase in the prices of most commodities and services, thus, raising the inflation rate, currently standing at 8.76%[6]. In turn, this, accompanied by the increase in taxes, will have a negative impact on private consumption, the main driver of the Egyptian economy that made up around 80% of the GDP in 2012/2013. In turn, a decline in private consumption can induce a decline in private investments. Therefore, the reforms will put negative pressure on the GDP in the short-term. The government is targeting a GDP growth rate of 3.2% in 2014/2015, which is not too high given the potential of the Egyptian economy.

[3] References: Egypt Independent, MadaMasr
[4] Fiscal consolidation is a policy aimed to reduce budget deficit through spending cuts or tax increases.
[5] "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation". World Economic Outlook, 2010
[6] Central Bank of Egypt



However, in the Social and Economic Development Plan 2014/2015, it is stated that the expected private consumption will account for 81.5% of the GDP and 3.2% of the growth rate, even more than the 2012/2013. The government is expecting the private sector to contribute with EGP 206 billion or 61% of the total investments in 2014/2015.

It is unclear if the government did not factor in the short-term effects of the implemented reforms or that it is confident of taking the right measures to counter them. In order for the government to reach the required, and the much anticipated, growth levels, more holistic growth-enhancing reforms need to take place[7]. Policies engineered to combat the short-term effects of the reforms, encourage private local and foreign investments and provide a cushion for the poor need to be taken. Since the new budget records a decrease in public spending on social welfare programs as a percentage of the GDP (17.9% from 18.8), optimal targeting of the funds is required. Public expenditure needs to be targeted efficiently and effectively in a transparent manner. The bold reforms were badly needed, but there is still a long and bumpy road ahead of us.

Presidential Decree 187 for year 2014 to form the Supreme Committee for Legislative Reform[8]

The Decree states that the Supreme Committee for Legislative Reform should be formed headed and presided over by Prime Minister Ibrahim Mehleb. The Minister of Parliamentary Affairs and transitional justice will be scheduled for the committee to replace the Prime Minister in his absence.

The Committee will include the membership of the Minister of Transitional Justice, Minister of Parliamentary Affairs, Chief Justice of the State Council Court, Egypt's State Mufti, and the Deputy Chief of Al-Azhar, along with representatives from the Ministry of Justice, and Cabinet Advisors.
Furthermore, the committee also consists of three professors of university law faculties, two judiciaries, two lawyers and three legislators.

The committee will be tasked with preparing, researching and studying draft laws as well as decrees issued by the president and prime minister that must be issued or amended in order to comply with the articles of the 2014 constitution. Moreover, the committee will be responsible of the assurance of draft bills and decrees developed by ministries, in addition to removing any duplicity, contradictions or ambiguity in legislation.
This decree was welcomed by many people who believe that Egypt has many existing economic legislations that require immediate revision because they are considered burdens to investors.

Competition Law and Prohibition of Monopolistic Practices

PresidentAbdel FattahAl-Sisi has issued a decree amending some provisions of the law number 3 of the year 2005to protect competition and prevent monopolistic practices. These amendments come in line with the provisions of chapter 2 of the constitution which emphasized on the importance of

[7] "Strategies for Fiscal Consolidation in the Post-Crises World", "Abbas et al", IMF
[8] References: MadaMasr, ahramonline

supporting competitiveness and prevent monopolistic practices. It also allows the free exercise of economic activity, in order to achieve economic development and safeguard the interests of all parties.

The law was identified as containing several loopholes. There were 19 amendments most importantly, imposing harsher punishments that ranges between 2 and 12% of the total revenues incurred by a product in violation of the law and between EGP 500 thousand and EGP 500 million if there were limitations with calculations. Producers convicted of practices that limits competition will be fined between 1 and 10% of the revenues or between EGP 100 thousand and EGP 300 million, to be doubled if the violation occurred again. In addition, the amendments constituted that the majority of members of the Competition Authority have to agree before the filing of a law suit or reconciling with any of the violators. Moreover, contracts and agreements between competitors will be pardoned if they are found to raise economic efficiency.

Conclusion

Through the years, redundant policies and regulations and the lack of political will to change them have caused serious and chronic distortions to the Egyptian economy. The state of chaos witnessed by the country for three years has amplified the need for conducting the painful, but much-needed reforms. With this wave of reforms, President Al Sissi signals the start of a new era where the government not only acknowledges the defects in the economy, but also is not afraid from implementing the taboo reforms.

In conclusion, it is expected that these reforms are merely the first wave with several more to follow after the parliamentary elections. While this wave did reduce the budget deficit to 10% of the GDP, it is still above the desired level. In addition, Egypt's tax revenues are way below the international levels. Consequently, it is expected that more tax reforms will follow. The first of which will be the implementation of the real estate tax after being postponed from 2008 which will generate around EGP 3.5 billion. The VAT system is anticipated to be implemented, at least on certain goods, which can possibly generate around EGP 20 billion. The government has also considered raising taxes on certain sectors, mainly cement, telecommunication and carbonated soft drinks. For cement, it was voiced that the sector has been enjoying huge profit margins for years and that there is an opportunity to tax the sector more heavily without significantly affecting the price of the commodity. As for telecommunication, the fact that free minutes are not being taxed hitherto, presents a lucrative opportunity for the government.

The government will be well aware that adding more taxes may scare away the much-sought-for investments. To nullify that effect, the government has to start vigorously reforming and amending the cumbersome regulations and procedures which have been identified as a major constraint to doing business. More transparent, clear and efficient regulations and procedures governing investment, trade and industry are necessary to attract investors. The government acknowledges that, as apparent by the formation of the Supreme Council for Regulatory Reform, and is expected to amend a large number of regulations once there is a parliament in place. The government will also work to cut the tedious bureaucratic procedures required for a business to start operations.

The public, especially the poor, are expected to suffer in the short-term. Yet, the fact that there were no major protests to the reforms indicates that the public acknowledges the problems and sees the need swift solutions. However, people's expectations have risen sharply and they are waiting for the government to deliver growth and welfare. The government states that it is on the course of adopting policies to better target social spending that has been unfair for years. In order to cushion the effect of the latest reforms, the government adopted the minimum wage law, increased social security pensions and allocated more money for social services. Yet, many argue that the current social safety nets are not sufficient to protect the poor in the short-term. The government is expected to exert more effort in raising the efficiency of social spending, taking actions to move towards cash transfers. Officials have also pledged to meet the constitutional requirements for public spending on social services by 2017.