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Ministry of International Cooperation
The Minister

Dr. Jim Yong Kim
President
World Bank Group

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Arab Republic of Egypt
Economic Reform Program
(2014-2018)
Letter of Development Policy

Dear President Kim,

The Government of Egypt, in June 2014, launched a well-structured comprehensive Economic Reform Program (2014-2018), with the objective of restoring macroeconomic imbalances, addressing social inclusion priorities, and achieving high, sustainable and well-diversified growth. The Government has made clear strides toward restoring confidence in the economy through serious and comprehensive reforms, while moving steadily on advancing its political roadmap. To get the economy back on track, the Government has developed a credible, sustainable and effective reform Program with a clear vision. The Program comprises of three key pillars, namely: (i) advancing fiscal consolidation; (ii) ensuring sustainable energy supply; and (iii) improving the business environment.

The Program is designed to restore confidence in the economy's prospects by tackling Egypt's macroeconomic imbalances, addressing social needs, and eliminating infrastructure deficits, including the shortfalls in1` the power and transportation sectors. It establishes a new foundation for sustainable growth by incentivizing productivity, investment and job creation. Above all, it puts the economy on course to meet the legitimate demands of the Egyptian people for lives of greater stability, security and dignity, as well as to deliver a meaningful improvement in the quality, range, and accessibility of services to which they are entitled, attaining their aspirations of a better future.

The Government's key objective is to create a productive, efficient, private sector-led and ultimately more dynamic economy and to ensure that future growth is high, sustainable and inclusive. Structural steps have been taken to enhance the business environment through streamlining investment procedures, strengthening the competition framework and upgrading the industrial licensing regime. Among the boldest moves so far was the Government's decision to slash wasteful energy subsidies bill by 30 percent in July 2014, signaling its political will to confront even the most difficult issues in its quest to reinvigorate the economy. Other decisive steps have included measures to improve tax buoyancy and widen the tax base, to contain the wage bill, to diversify the energy mix, to begin the process of liberalizing the power sector generation and distribution activities and to reposition the role of the state to that of regulator and supervisor.

In effect, the Government is reengineering the Egyptian economy through a comprehensive set of coherent policies, programs and projects. The Government is committed to restoring macroeconomic imbalances within the context of a plan that concurrently focuses on social protection, health and education priorities, alongside policies to facilitate job-creating private sector investments.

The macroeconomic policy framework and structural reform program rest on three fundamental principles:

- First, pursuing prudent macroeconomic policies in tandem with long-term economically viable developmental projects with high labor intensity and concrete efforts to improve the quality and accessibility of services offered to the public.
- Second, reforming the legal apparatus, and investing in basic infrastructure in order to create a stable and predictable business environment, while the private sector is being increasingly empowered and encouraged to resume its leading role in driving economic growth. The growth model will be based on a constructive partnership between the Government and the private sector.
- Third, ensuring that growth is inclusive, as well as, sustainable, with public expenditure being reprioritized and savings generated by reforms being partially redistributed to fund social protection programs and to invest in Egypt's abundant and young human capital. The approach will strike a balance between macroeconomic stabilization including advancing pro-growth fiscal consolidation and social justice objectives.

Within this overall framework, three areas of the Government's program will be particularly critical to its success. These are addressing fiscal consolidation, ensuring sustainable energy supply and improving the business environment.

Advancing Fiscal Consolidation

The Government's recent five-year macroeconomic framework and strategy (Fiscal Year (FY) 14/15-FY18/19) were presented at the Egypt Economic Development Conference in March 2015.

Fiscal consolidation to narrow the deficit and put Government debt on a firm downward path while creating room to shift spending to more effective and productive uses is a key pillar to achieve macroeconomic stabilization. Among others, increased spending on physical and human capital, including higher outlays on education, health and research and development constitutes part of an integrated strategy for achieving inclusive growth.

Early in FY15, the Government frontloaded the consolidation program with several structural revenue and expenditure measures, bringing the overall deficit down to about 11.5 percent of gross domestic product (GDP). Accounting for additional outlays needed to enhance social services, the Government is targeting a further 3—4 percent decline in the deficit over the four years through FY19. By the end of the plan, the budget deficit will fall to around eight percent of GDP and Government debt will fall to 80—85 percent of GDP.

The medium-term fiscal program will not merely focus on narrowing the deficit and reducing the debt (although these are critical primary goals), but will also bring about a more efficient, well-functioning economy. Moreover, thanks to its design, the fiscal consolidation is not expected to negatively impact the economy's growth prospects as it will primarily rely on phasing out inefficient spending, reprioritizing public expenditure, enhancing public financial management and widening the revenue base. Finally, the Government's comprehensive reform program is self-reinforcing by setting up a virtuous cycle of fiscal consolidation and growth. As the Government phases out inefficient spending, it not only frees up room for more productive uses of spending but also crowds in the private sector. This will drive growth, supported by the legislative and structural reforms to the business environment. In turn, the pickup in growth will enhance fiscal revenue performance and further reinforce the fiscal consolidation effort.

Tax policy aims to widen the tax base to create a fairer and more equitable system. This started with amending the income Tax Law No. 91 of 2005 to pave the way for a stable and predictable income tax policy. The amended law unifies the corporate income tax rate for all firms and establishments at 22.5 percent, matching the highest personal income tax rate. The new unified rate will be applied to all economic actors operating in Egypt, including those located or based in Special Economic Zones. By addressing the preferential treatment in these zones, Egypt can address current tax arbitrage, widen its tax base and improve revenue buoyancy going forward in light of the Government's plans to expand the economic zone model across the country.

The Government is also committed to advance the Value Added Tax (VAT) law that aims to broaden the tax base and promote a fairer and more equitable tax regime that departs from the distortions embedded in the current goods and services tax (GST) regime. By unifying the tax rate and introducing an effective credit/refund mechanism, the VAT regime will serve to improve firm cash flow while reducing the need of businesses to resort to debt to finance normal operations. In fact, moving to a fully-fledged VAT regime and advancing tax efficiency has been a longstanding demand from the business community. Equally important, the new VAT law is being carefully designed to mitigate adverse impacts on the poor by maintaining exemptions on the goods and services they consume. The Government also envisages introducing a harmonized and simple tax regime for micro and small businesses based on turnover, to reduce compliance costs and encourage private business growth.

Furthermore, the Government has taken bold measures to control wages and avoid future wage creep. This has become a pressing priority in light of the considerable increase in the wage bill post 2011, driven in part by the permanent hiring of temporary workers, increasing wages of various groups in a non-harmonized manner, and by two hikes in the minimum wage. A shift in policy began in FY14 and continued in FY15 as the Government adopted reforms to: (i) abolish the tax exemption of the new bonus component of civil servants' compensation; (ii) discontinue the practice of adding the special bonus to the basic pay after five years; (iii) delink the variable portion of employees' salaries from the basic salary component; (iv) improve and simplify the wage setting process; (v) centralize all new hiring through the first chapter of the budget only; and (vi) contain further increases in bonuses and rewards to all government employees, including those self-funded through public entities' own resources. These steps will be complemented by a plan encompassing procedures and measures that facilitate the automation of wages and salaries payments for all government employees. These reforms are projected to reduce the wage bill by 1.5 percent of GDP during FY14—19.

The Government continues to pursue its key debt management objectives over the medium-term, focusing on further lengthening the average maturity of the debt profile, diversifying sources of financing, and reducing the average cost. Fiscal consolidation to reduce the deficit to around eight percent of GDP by FY19 will be the main tool to sustain confidence and support the debt management policy, in addition to enhancements to the Government's treasury function. Moreover, the Government will seek to expand its sources of financing both domestically and internationally as well as to develop new instruments to widen the investor base. With the combination of these various strategies, the Government is targeting to steadily expand the average life of the tradeable domestic debt to at least three years by FY19.

The Government is also committed to work on enhancing transparency and accountability. This started with the Ministry of Finance resuming the launch of the Citizen's Budget to enhance public engagement in the decision making process by presenting information about the policies underlying revenues collection and expenditure allocations in the general state budget to citizens in a transparent and accessible manner. Also, the Government has presented and published its medium-term macro-fiscal framework, which informs the public about the Government's macro-fiscal and debt targets and expected reforms. Looking ahead, the Government intends to publish other key fiscal documents and to enhance citizen engagement at all stages of the budget process. The Ministry of Finance will also establish an internal audit function to oversee controls over public resource use, in addition to implementing a broad array of public financial management reforms.

Ensure Sustainable Energy Supply

The Government of Egypt has a clear concrete strategy, and has already undertaken numerous measures to ensuring sustainable energy supply and enhance energy security. The Government's medium term plans for the energy sector were laid out in our recent White Paper, *Energizing Egypt,* that was presented at the Egypt Economic Development Conference in March 2015.

With the recent passage of the new Electricity Law No. 87 of 2015, the electricity sector has embarked on a process of market liberalization to encourage private sector investment in both conventional and renewable energy. This will entail gradually sharing responsibility for power generation and distribution between public and private sector. In particular, the Government is committed to transferring a substantial share of some of the new power generation plants currently under development to new companies with a majority share of private sector participation. Responsibility for the transmission network, along with system and market operations will be retained by a newly established Transmission System Operator and Market Operator, that shall provide open access to the national power grid. The new law also significantly strengthens the powers of the electricity regulator, the Egyptian Electric Utility and Consumer Protection Regulatory Agency (EGYPTERA), providing a stronger voice for consumer participation in its governance structure.

A similar set of market-oriented reforms is also underway for the gas sector, a key supplier of primary fuel for power generation. The Cabinet has recently endorsed a new gas bill that will provide open access to gas transportation infrastructure to allow for competitive supply, and establish an independent gas regulator to protect consumer interests.

The move to adjust energy prices in July 2014 (an adjustment that alone amounted to two percent of GDP) heralded the start of a medium-term plan to reform the energy subsidies to 0.5 percent of GDP by 2018/19. Prices increases ranging from 40 to 78 percent were introduced for the majority of fuel products, whereas a detailed five-year plan for the adjustment in electricity prices for various uses was enacted by Prime Minister Decree No. 1257 of 2014. The latter was slightly adjusted in 2015 to shift the burden of adjustment to higher consuming segments, with the aim of alleviating the burden upon lower income groups. By the end of the five-year horizon, this plan would retain only those subsidies for vital fuel products and basic electricity consumed by the poor. Recognizing that the achievement of this target can be affected by movements in international fuel prices, the Government has tasked a tri-partite ministerial committee, comprising the Ministries of Finance, Petroleum and Electricity, to agree upon a mechanism for financing of changes to actual fuel cost due to variations in international oil prices and exchange rates, and passing through those costs in a transparent methodology to consumers.

The addition of new power capacity installed this year backed by new liquefied natural gas (LNG) import contracts, as well as efforts to reinvigorate domestic gas exploration and production through repayment of pending arrears to foreign oil companies, and issuing new production sharing agreements all these efforts resulted in no power outages during the summer of 2015. This will also ensure the provision of adequate power to serve both residential and industrial demand. The Government will continue to meet the growing economy's demand for power in a proactive fashion over the coming years, supported comprehensive energy market reform and the elimination of energy subsidies, as outlined above.
Egypt strives to become a regional leader in renewable energy. With the issuance of the Renewable Energy Law No. 203 of 2014, a policy framework has been set in place to reach the target of 20 percent of energy through renewable sources by 2022. This has been followed by a transparent process of issuing regulations for Feed in Tariff, and award of interim licenses. A private sector led program for 4,000 MW of grid connected solar projects, and 300 MW of decentralized solar applications has the potential of transforming the clean energy sector in Egypt, sparking a stream of local entrepreneurs and the creation of jobs.

These reforms are expected to curb the growth in energy demand through the gradual shift towards cost reflective pricing, and to reduce the use of heavy fuel oil and diesel in favor of natural gas and clean energy. This in turn will reduce greenhouse gas (GHG) emissions in the power sector by about 20 percent, which contributes more than one third of GHG emissions in Egypt.

The importance of the subsidy reform has multiple dimensions. First, it shifts incentives away from capital-intensive economic activity toward the labor-intensive activity that Egypt needs. Second, it also signals an essential qualitative improvement in the nature of Government spending, with the Government shifting away from wasteful and regressive areas of spending in order to create room for expenditure on capital investment, public services and targeted cash transfers. Reflecting this shift, the budgetary allocation in FY 2014/15 for health and education exceeded energy subsidies for the first time in many years. This was a policy choice that the Government made well before the sharp decline in global oil prices after October 2014 further reduced the weight of energy subsidies in the budget.

Improving the Business Environment

The Government is committed to enhancing the domestic investment environment as part of its broader macroeconomic strategy prioritizing private investment-led growth. To that end, it has engaged in an active and wide-ranging process of legal and regulatory reforms in order to cut red tape and streamline procedures for doing business, to foster transparency, and to ensure a level playing field. In addition, the Government has been solving outstanding investor disputes to demonstrate its commitment to a strong investment environment.

A number of laws have been amended or newly introduced to strengthen the domestic business environment and reinforce the rule of law. Highlights of legislative reform include the new investment law, which enhanced the scope of services provided by the one-stop shop, thereby streamlining various processes for investors. The new investment law, addresses the obstacles that face investors and significantly enhances the business environment in accordance to international standards. By enabling the General Authority for Investments (GAFI) to facilitate registration, licensing procedures, and other services by all Government entities on behalf of the investor, the law simplifies investment procedures for investors and significantly reduces the time needed for issuing investment licenses, procuring land, and obtaining utilities services for investors. The new investment law also includes a dispute resolution mechanism based on international best practices. Other important legislations that have recently been passed to enhance the conditions for doing business in Egypt are the microfinance law and amendments to the competition law.

The main purpose of the amendments introduced to the competition law and proposed amendments to its executive regulation is to create a more competitive marketplace for investors by enhancing the role of the Competition Authority in regulating markets and ensuring competitive practices. The law ensures the Authority's independence by allowing it to file lawsuits and settle cases against violators independently. In addition, the law strengthens the Authority by enabling it to enforce anti-cartel policies. The Government will continue to enable and enhance implementation of the law through enactment of the executive by laws and regulations.

The Government is laying down better foundations for the growth and development of the small and medium enterprise (SME) sector through enhancing financial inclusion. The microfinance law, passed in November 2014, has opened a channel for microfinance to grow and support the SME sector. Furthermore, a law for secured transactions is being drafted to enable SMEs to use movable assets as collateral.

Improving the ease of doing business is a policy priority of the Government. This entails a thorough review of business procedures in Egypt including those with regard to access to land, issuance of permits and licenses, inspection procedures, customs clearance, tax payments and compliance, and other sector-specific regulations. Accordingly, and as a first step, the Government has prioritized a review of the process of industrial licensing, whereby inter-ministerial committee has been formed to propose a roadmap for complete overhaul of the industrial licensing process by the middle of 2016.

Inclusion

As Egypt moves forward with these needed reform programs, the Government has taken important steps to mitigate potential adverse impacts on the most vulnerable segments of the society. Such mitigation measures have paramount importance for today's Egypt, given the unique and distinctive development challenges that the country is facing. Egypt's own experience showed that growth alone will not result in poverty reduction or improvements in shared prosperity.

Fiscally, expensive and inefficient policy choices in the past have resulted in large public debt and the erosion of external and domestic buffers. Geographically, Egypt is one of the most agglomerated countries in the world, with 95 percent of the population living on only five percent of the land and with the poverty rate in rural Upper Egypt at over 50 percent, compared to less than ten percent in metropolitan Egypt. Demographically, Egypt faces a "double" youth bulge, with a large generation currently in its mid-to-late 20s and even larger generation below age of ten that will soon enter the labor market.

Through effective social protection measures, the Government will promote more inclusive growth, reduce regional disparities, improve human development and protect the poor and vulnerable, while pursuing the necessary economic and structural reforms. In this regard, as stated elsewhere, Egypt has already initiated the process of establishing a more efficient social safety net system that would enhance opportunities for the poor and disadvantaged and move away from the inefficient subsidy system. The Government is committed to meeting the provisions of the Constitution for increasing social sector expenditure to ten percent of GDP.

In fact, significant changes to the Social Safety Nets (SSN) include the following:

- The recently introduced poverty-targeted Takaful and Karama Program (TKP), aims at protecting the poor through direct income support. Takaful provides conditional cash transfers to poor families with children (co-responsibilities for school attendance and child health visits) and Karama is an unconditional income support program targeted to poor households with elderly (age 65 and older) or with persons with severe and permanent disabilities.[1]
- The food subsidy scheme was overhauled, whereby the Government currently subsidizes the final product (loafs of bread distributed by the bakeries to consumers) through the smart card system instead of subsidizing the flour for bakeries producing Baladi bread.
- The in-kind food system has been shifted to a semi-cash transfer scheme which allows beneficiaries to decide on their own consumption patterns, replacing the old four commodity system. The enhanced system offers an allowance of LE15 per individual per month that can be spent on over forty commodities widely used by Egyptian households. During the early

[1] Takaful provides a base amount of EGP 325 per household per month and with additional top-ups depending on the number of children attending school, up to a maximum amount per household of EGP 650 per month. In Karama, the benefit size is EGP 350 per beneficiary with a maximum amount per household of EGP 1,050. The program is expected to enroll about 1.5 million beneficiary households by end 2017, with a phased rollout in three consecutive waves. The Wave 1 roll-out has begun in the 19 poorest districts (with estimated poverty at 60 percent or higher), all in Upper Egypt, and aims to cover about 500,000 households by 2015.

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stage of implementation, the system has witnessed significant success attested to by the surge in participation rates.

- Egypt established a Labor Intensive Works Program (LIWs) that targets the able-to-work poor and unemployed youth, with a focus on those living in poor and lagging regions. During the period 2013-2015, the LIWs program delivered over 12 million employment days benefiting a total of 80,000 poor individuals of whom 60 percent were females and 70 percent were youth (18 to 29 years of age).
- An ongoing initiative to establish a Unified National Registry (UNR) with technical assistance from the World Bank will support different SSN programs and facilitate coordinated targeting and delivery of social services.

The Government is committed to the massive re-engineering of Egypt's entire economic apparatus. The economy is being restructured and retrofitted so that it can reach its full potential. At the same time, lessons learned from Egypt's last economic boom during the mid-2000s are being applied to make sure that this time around, growth will benefit all Egyptians and not just the few. This means that we will ensure that the fruits of the growth are fairly distributed and that the burden of adjustment falls most on those with the capacity to shoulder the impact, while the most vulnerable are protected.

This comprehensive reform program is already yielding promising results. Growth has accelerated to 4.6 percent during July-March FY 2014/15, following several years of annual growth hovering at only two percent; unemployment rates decreased significantly to reach 12.7 percent in 2015; the deficit as a percentage of GDP declined, amounting to 12.5 percent of GDP; and the fuel subsidies as percentage of GDP has been cut into half to reach 3 percent only.

The expected outcome of all these policies, programs and projects is two-fold: to ensure long-term sustainability by correcting the country's microfinance imbalances, and to create a dynamic, competitive and private sector-led new platform for inclusive growth.

Sincerely,

Sahar Nasr

Ministry of International Cooperation