ERF Economic Research Forum
POLICY BRIEF

ERF Policy Brief No. 23 | May 2017

Egypt Must Strengthen Budget Institutions to Curb Mounting Budget Deficit

Mohamed Zaky

About the author

The author holds a PhD in economics. He is an economic expert and external lecturer in economics, Faculty of Economics and Political Science (FEPS), Cairo University.

In a nutshell

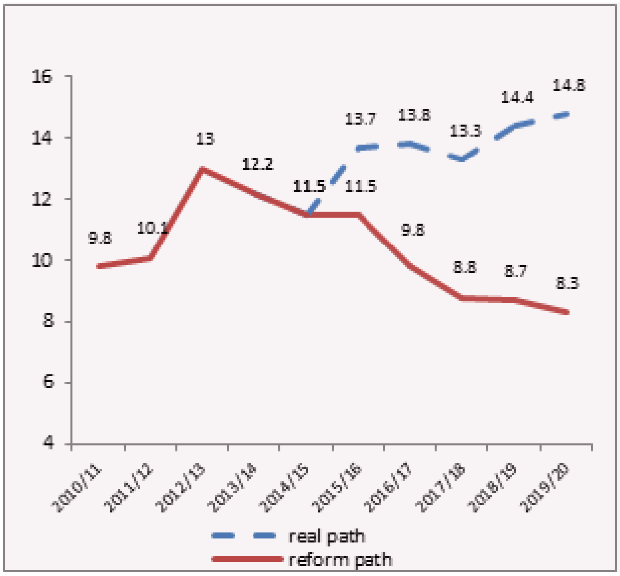
- *Since the January 2011 popular revolution, the budget deficit in Egypt has worsened.*
- *A new strategy announced by the government to contain the budget deficit and control public debt includes many measures to raise revenues and cut expenditures.*
- *However the strategy did not include any measures to reform budget institutions, which suffer from structural weaknesses that are highly likely to contribute to further rises in the deficit.*
- *These weaknesses include: a lack of fiscal rules; a right for parliament to raise borrowing for current spending; and a dual system that separates the accounts of 700 economic authorities from the national budget.*
- *To prevent further rises in budget deficits and public debt, the government must reform the budget institutions to improve the structures, rules, and procedures that govern the formulation, approval, and execution of government budgets.*
- *In the immediate term the government must enforce the golden rule that it will borrow only to invest and not to fund current spending over the economic cycle, and establish a two-stage system of budget voting to limit the extent to which MPs can push for higher public spending.*
- *Over the medium term, the government should adopt performance-based budgeting, eliminate budget dualism, establish a medium-term budgeting framework, and improve fiscal transparency procedures that highlight the real values of the budget deficit and the annual accrued financial transfers from public economic authorities.*

1. Introduction

Since the popular uprising in the revolution of January 2011 and its subsequent economic and political adverse conditions, Egypt's fiscal imbalances have worsened. This has been due to dramatic increases in both the non-discretionary expenses such as wages and salaries (because of workers' strikes and demonstrations, appointment of temporary employees and applying minimum wage policy), and in subsidies and social benefits. The annual expenses on current expenses (wages, subsidies, and social benefits) doubled during the period 2010/2011to 2015/2016.

Accordingly, the overall budget deficit increased from 9.8% in 2010/2011to 11.5% of GDP in 2014/2015. Public debt increased from 82.1% in June 2011 to 98.4% of GDP in December 2015. As a result, interest payments amounted to around a third of the annual budget expenses (Egypt's Ministry of Finance, 2016).

Figure 1: Overall Deficit % of GDP



Source: Egypt's Ministry of Finance, (2016), Financial statement of draft budget for the fiscal year 2016/2017.

2. Government strategy contains budget deficit…for now

Based on its current or "real" path, the budget deficit is expected to reach 14.8% of GDP in 2019/2020 (figure 1). In order to reduce this deficit to 8.3% by GDP in 2019/2020, the Ministry of Finance has set out a strategy including measures to increase revenues such as a move from a sales tax system to a value added tax (VAT) system, and adopting a new law on mineral wealth and quarries. On the expenditure side, government has adopted measures to control current expenditures, reform the subsidies system, and contain the wages and salaries bill.

However the government's measures to contain the budget deficit does not include any strategic reforms to address the noticeable weaknesses in budget institutions in Egypt, despite the weight of academic literature and empirical studies that show a positive relationship between strong budget institutions and better fiscal performance (Zaky & El Khishin, 2016).

3. Budget institutions suffer from critical weaknesses

In order to undertake the structural reforms needed to put the government budget back on a strong and sustainable path, policymakers will need to address the weaknesses in Egypt's budget institutions. There are three essential weaknesses in budget institutions in Egypt. The first is an absence of numerical rules on public expenditure and budget deficit: neither the constitution nor budget laws enforce legal restrictions or numerical rules on public expenditure or the budget deficit. Since 2005, budget law amendments have violated the golden rule of fiscal policy that over the economic cycle, the Government will borrow only to invest and not to fund current spending. Second, the House of Representatives has a constitutional right to increase public expenditure as long as it does not impose any financial burdens on citizens such as extra taxes or duties. This means that substantial increases in borrowing are the most likely way to finance proposed increases in public expenditure at the budget approval stage.

Third, there is a lack of transparency over the finances of public economic authorities and their link to the national budget. Public economic authorities are public entities but are not included in the national budget. These authorities act as the government's arms in providing subsidized goods and services for the society. This creates a dual structure within the budget system. Furthermore the application of different accounting bases leads to a further lack of transparency: public budgeting is on a fully cash basis, while the economic authorities apply accrual based accounting.

4. Weaknesses in budget institutions impose negative side effects

These weaknesses in the budget institutions have significant negative side effects. First, violating the golden rule results not only in an increase in the deficit as a percentage of GDP, but also in substantial changes in the structure of the budget deficit. Second, allowing the government to finance current spending from borrowing give it leeway to finance substantial increases in current spending out of borrowing at the expense of public investment. This has resulted in a decrease in public investment from 13.9% of total expenditure in 2003/2004 to only 6.5% in 2015/2016 (Egypt's Ministry of Finance, 2016).
At the same time that current spending has enjoyed a significant increase. These structural changes in public expenditure and the budget deficit expose public finance to future risks.

Third, the non-transparent financial relations between the national budget and public economic authorities result in a growing shortage in cash flow from the national budget to some economic authorities. This growing shortage means that part of the annual budget deficit is concealed in the income statements of these economic authorities. Many of these authorities are forced to finance their annual losses depending on borrowing and short-term credit facilities. The cash-based accounting in public budgeting results in a lack of transparency in budget appropriations, poor fiscal accountability and causes hidden increases in the budget deficit.

5. Budget deficit problems will worsen unless addressed

There are three factors that will aggravate the negative side effects of weak budget institutions on budget deficits over the coming years. The first is the political fragmentation embedded within the parliament's structure. Parliament is based on individual rather than parties. MPs who are independent of parties gained 54.5% of seats in the last parliament elections for both individuals and party lists. The percentage of parties' seats in parliament is 40.8% distributed between 19 parties. This hinders the formation of coalitions in parliament. Since independent MPs usually have a direct relationship with voters, their priority is often to increase public spending for their constituencies. Furthermore the large number of MPs (596) and parliament's committees (28) affect fiscal prudence adversely during the enacting stage of the budget cycle (Zaky & El Khishin, 2016).

Second, there are about 700 budget authorities within the overall budget system. Each has to prepare and discuss its budget with the ministry of finance. This leads to more fiscal fragmentation and inefficient use of public resources.

Third, additional financial resources are required to fulfill citizens' constitutional rights. The constitution commits the government to allocate at least 3% of annual GNP on health spending and to increase this percentage gradually to comply with international rates. The government has also committed to establish a comprehensive health insurance system for all Egyptians that covers all diseases. There is also a commitment to allocate at least 7% of GNP for spending on education and scientific research and to increase this percentage gradually to comply with international rates. Meeting these commitments will add further financial obligations on annual budget appropriations (Egyptian Constitutions, 2014).

6. Recommendation for strengthening Egypt's budget institutions

To prevent further rises in budget deficits and public debt, the government must reform the budget institutions to improve the structures, rules, and procedures that govern the formulation, approval, and execution of government budgets. This will involve implementing both short- and medium-term reforms of the budget institutions in order to contain the budget deficit.

In the short term policymakers should enforce the numerical rules on budget deficits or, at the very least, reapplying the golden rule to prevent increases in borrowing to finance substantial increases in current spending. They should also apply a top-down approach for voting in budget approval stage so that the legislature votes on budget in two separate stages:

- A votes on fiscal aggregates
- A vote on the allocation of resources to different budget chapters and functional sectors.
- The two-stage approach of budget voting is likely to limit the extent to which MPs can use their bargaining powers to push for higher public spending.

The government should then legislate for four medium-term reforms:

1. Accelerate the application of a program-based budgeting system as a first step to adopting performance-based budgeting in the medium term.
2. Adopt a medium-term budgeting framework to achieve three targets:
- A safety margin of a specific percentage of GDP deficit limit
- Rapid progress towards fiscal sustainability
- Create room for budgetary maneuvers.
3. Solve the budget dualism problem in order to improve budget consolidation.
4. Improve fiscal transparency procedures and strengthen cash base accounting by including notes that disclose the real values of budget deficit and total annual accrued financial transfers for public economic authorities.

References

Egyptian Constitutions for the year 2014.

Egypt's Ministry of Finance, (2016), financial statement of draft budget for the fiscal year 2016/2017.

Zaky, Mohamed & El Khishin, Sarah, (2016), Fiscal Governance in Egypt: Strengthening Budgetary Institutions to Counteract Political Fragmentation, International Journal of Economic Research, Volume: No.13 (2016) Issue No. : 7.

Recent Policy Briefs

"Mechanization to Drive a Process for Fertilizer Subsidy Reform in Egypt" *by Shinan N. Kassam and Boubaker Dhehibi, ERF Policy Briefs No. 22, December 2016.*

"The Impact of Emigration on MENA Labor Markets" *by Anda David and Mohamed Ali Marouani, ERF Policy Briefs No. 21, October 2016.*

"The US Fracking Boom, Oil Prices and Policy Options for Arab Oil Producers" *by Romesh Vaitilingam, ERF Policy Briefs No. 20, October 2016.*

"Labor Market Regulations: Job Security versus Labor Flexibility" *by Jackline Wahba, ERF Policy Briefs No. 19, September 2016.*

"Are Export Sanctions Effective?" *by Jamal Ibrahim Haidar, ERF Policy Briefs No. 18, September 2016.*

"Low Social and Political Returns to Education in the Arab World" *by Ishac Diwan, ERF Policy Briefs No. 17, August 2016.*

"School Based Management: An Approach to Improve Learning Outcomes in Egypt" *by Engi Gamal Eldin, ERF Policy Briefs No. 16, August 2016.*

"Tackling Poverty and Poor Health in Turkish Widowed Households: State Benefits Work" *by Oznur Ozdamar and Eleftherios Giovanis, ERF Policy Briefs No. 15, June 2016.*

"Boosting World Trade in Tunisia and Egypt by Cutting Non-tariff Barriers: Better Imports for Better Exports" *by Zouhour Karray, ERF Policy Briefs No. 14, June 2016.*

"Employment and Rates of Return to Education in Arab Countries: Gender and Public Sector Perspectives" *by Zafiris Tzannatos, ERF Policy Briefs No. 13, June 2016.*

"Reducing Air Pollution in Cairo: Raise User Costs and Invest in Public Transit" *by Alban Thomas, ERF Policy Briefs No. 12, May 2016.*

"Trade Liberalization in Egypt: Let the Informal Labor Market Take the Strain" *by Abeer Elshennawy, ERF Policy Briefs No. 11, May 2016.*

"Replace Discretion with Rules: How Policy Reform Can Boost Economic Performance " *by Izak Atiyas, ERF Policy Briefs No. 10, May 2016.*

"Sticks Rather than Carrots to Induce More Formality" *by Aysit Tansel, ERF Policy Briefs No. 9, April 2016.*

"Modifying the Path of Fertility Rates to Accelerate Egypt´s Entry in the Demographic Window" (in Arabic) *by Sara El Khishin, ERF Policy Briefs No. 8, April 2016.*

"Going beyond Doing Business to Foster Job Creation in Arab Countries" *by Jamal Ibrahim Haidar and Hedi Larbi, ERF Policy Briefs No. 7, April 2016.*

“The Quality of Educational Performance of Students in The Middle East and North Africa Much Remains to Be Done” *by Donia Smaali Bouhlila, ERF Policy Briefs No. 6, December 2015.*

“Untapping Low Female Labor Force Participation In Egypt: Ending The Marriage Mismatch” *by Rana Hendy, ERF Policy Briefs No. 5, September 2015.*

“Improving Health Status in Turkey: Combating Pollution” *by Oznur Ozdamar and Eleftherios Giovanis, ERF Policy Briefs No. 4, September 2015.*

“Farmer Access to Formal Credit Institutions in Kassala, East Sudan: Determinants and Possible Ways Forward” *by Ebaidalla Mahjoub Ebaidalla and Eltyeb Mohamdain Abdalla, ERF Policy Briefs No. 3, September 2015.*

“Pension Reform: Securing Morocco’s Elderly” *by Najat El Mekkaoui de Freitas, ERF Policy Briefs No. 2, June 2015.*

“Transforming Egypt: Innovation and Diversification as Drivers of Growth” *by Markus Loewe, ERF Policy Briefs No. 1, June 2015.*

ERF Contact Information

Address: 21 Al-Sad Al-Aaly St., Dokki, Giza, Egypt
Telephone: 00 202 333 18 600 - 603 | **Fax:** 00 202 333 18 604
Email: erf@erf.org.eg | **Website:** http://www.erf.org.eg

ECONOMIC RESEARCH FORUM

منتدى البحوث الاقتصادية