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How to end Egypt’s subsidies addiction

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Following the military takeover and the bloody crackdown on the followers of the Muslim Brotherhood, Egypt has been living through intermittent violence and unrest. Incidence of violence directed against the country’s Coptic minority seems to be on the rise, as does the activity of Islamists operating in the Sinai Peninsula. In short, this seems to be a very odd moment to discuss the arcane details of Egypt’s subsidy programmes.

However, the problem of energy and food subsidies is one of the most significant challenges facing Egypt today. Regardless of what political future looms for Egypt, a reform of subsidies is necessary to avert an approaching economic catastrophe.

Egypt’s government directs up to one third of public spending – or 13 per cent of the country’s GDP – to fuel subsidies such as diesel oil, liquefied petroleum gas (LPG), petrol, and natural gas, as well as various foodstuffs. Subsidies explain the dire state of Egyptian public finances, with a projected deficit of 15 per cent of GDP in the current fiscal year and with public debt at around 90 per cent of GDP. The economy is being kept afloat only by the inflow of aid from Gulf countries, including Saudi Arabia and the UAE.

This fiscal problem is magnified by the distorted incentives subsidies create, leading to overconsumption and waste. Because wealthier Egyptians tend to consume more of the subsidised commodities – particularly of energy – it is no surprise that they are the largest beneficiaries of subsidy spending. In urban areas, for example, the top quintile of the income distribution receives eight times as much in energy subsidies as the bottom quintile.

Moreover, many of the subsidised goods end up being resold on the black market. According to some estimates, this includes roughly one third of the subsidised bread and 20 per cent of the total supply of subsidised sugar and cooking oil. The same problem arises with bottled LPG, used for cooking, which is typically resold at ten times the subsidised price.

Egypt’s subsidy problem persists in spite of decades of half-hearted reforms. In January 1977, for example, President Anwar Sadat announced a modest reduction in subsidy spending on certain groups of commodities. What resulted were so-called bread riots in major Egyptian cities, which led the government to cancel the reforms. Since then, several other attempts were made, temporarily moderating the growth in subsidy spending but failing to bring it under control in the

longer run. Now, as the country nears insolvency, this might be Egypt's last chance to put in place durable reforms without hurting too many people in the process.
In a new paper, published on Wednesday by the Cato Institute's Center for Global Liberty and Prosperity, I argue that successful subsidy reform will require three fundamental features. Firstly, it will have to be quick and complete – unlike the partial adjustments that were made to subsidy programmes in the past. Every failed reform attempt causes Egyptian rulers to lose some of their credibility. If yet another partial reform is tried, people will simply refuse to take it seriously and instead demand, perhaps in a violent way, the preservation of the status quo.

Secondly, a successful reform will have to come as a part of a broader package of structural reforms. Egypt's energy markets are marked by heavy government involvement and lack of competition. Simultaneously, the patterns of Egyptian food prices display strong downward rigidities, with domestic prices not falling even when international prices do. That is a sign of uncompetitive, inflexible markets.

Thirdly, it is unreasonable to expect Egyptians to buy into the subsidy reform if the government does not commit to sharing its benefits with the population. Such commitment can take the form of cash transfers that would replace the existing commodity subsidies. After all, the enormous size of subsidy spending creates large opportunities for fiscal savings and for fairly generous payments to those in need. The government could essentially save half of its subsidy spending and still be able to pay every Egyptian household a sum of $373 annually. Or, with a basic system of means-testing in place, it could pay the poorest 40 per cent of households $933 every year while still spending only one half of what it currently spends on subsidies. That may sound modest, but Egypt's GDP per capita is only slightly above $3,000, and one quarter of the country's population is living on less than $37 a month.

Egypt's public debt is a ticking time bomb. Unless the country's policy makers address the problem of subsidies now, the citizens of the hard-tested Arab country can brace for new economic and social turbulences – with potentially even more damaging effects than previous episodes.