EGYPT

ESMAP

- Just-in-time technical assistance through analytical inputs to the reform process and capacity building
- Energy subsidies were slashed, allowing the percent of GDP spending on health and education to exceed subsidies for the first time
- Engagement opened doors for broader sector reform dialogue, leading to a three-year development policy loan program

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The Challenge

In the aftermath of the Arab Spring, Egypt's economy was adversely affected by a growing energy deficit, slowing economic growth, increasing poverty, and socioeconomic transition. The Government of Egypt faced growing fiscal pressures. With fossil fuel subsidies being a major contributor to the deficit, energy subsidy reform was a strategic priority for the government.

The Government of Egypt reformed prices of electricity and petroleum fuels several times over the course of the 2000s, but rising international oil prices meant that fossil fuel subsidies increased dramatically over the last decade.

In 2013, spending on energy subsidies comprised a large share of budget expenditure (22%). Fossil fuel subsidies amounted to 7% of Egypt's GDP, which was greater than the combined expenditures on health and education (5%). Cost recovery in the power sector was only at 30%, particularly low in liquefied petroleum gas (6%), diesel (22%), and gasoline (23-31%).

These subsidies were not only highly regressive and favored energy intensive sectors, but also hindered transparency and financial performance of public utilities, discouraging much needed investments in the power sector.

The Response

In 2013, the government requested the World Bank's support. With rapidly mobilized resources for technical assistance through the Energy Sector Management Assistance Program (ESMAP), the World Bank provided analytical inputs to the reform process and capacity building to various ministries following a cross-sectorial and phased approach.

During the first phase of technical assistance in 2014-15, just-in-time analytical inputs to the reform process and reviews of global experiences on subsidy reforms were provided. This included a presentation to the Cabinet of Ministers of estimated direct and indirect impacts of different subsidy reform options, based on a simulation of alternative scenarios, as well as a communication strategy, a political economy assessment, and just-in-time technical notes on various subsidy reform issues. This support contributed to the comprehensive and ambitious fuel and electricity reforms in July 2014.

Building upon this initial engagement, during the second phase of technical assistance in 2015-16, the World Bank provided just-in-time advisory support to the Egyptian Government on subsidy reform decisions and reforms to social safety nets. The support included a comprehensive study of gas pricing options; a diagnostic of social protection mechanisms and their ability to mitigate impacts in

the immediate and medium term; support to the modernization of databases for safety net targeting; and communication materials. Further during this phase, assistance focused on strengthening the Government of Egypt's capacity to model fuel price reforms, their impacts, and mitigation mechanisms. The project also conducted a backward-looking analysis of Egypt's 2014 reforms, including detailed distillation of key lessons, a review of some of the policy enhancements, and a roadmap for medium-term reform with policy options.

Phase II support provided timely inputs to the electricity reforms in both July 2015 and August 2016, as well as major reforms to fuel prices and social safety net programs in November 2016.

Outcomes

The first comprehensive reforms were publicly announced in July 2014. The Government increased prices of electricity and major categories of fuels by 40 to 78% with the goal of reducing fossil fuel subsidies to 0.5% of GDP by 2019 through periodic increases of fuel and electricity prices.

The 2014 reform changed how fuel subsidies are allocated between the electricity and oil and gas sectors. As part of the 2014 fuel price reform, the power sector purchase price for natural gas was increased by 69% from US$1.77/MMBtu to US$3.00/MMBtu.

Helped by the international fuel price decline, the fuel price reforms in 2014 and 2016, and electricity tariff reforms in 2014, 2015, and 2016, cost recovery reached roughly 60% on average for petroleum fuels in the budget for fiscal year 2017.

Supported by the World Bank's technical assistance, social programs were reformed substantially to mitigate reform impacts.

Egypt's fossil fuel subsidies, which had been on a long-term growth trajectory, decreased from 7.0% in FY2013/14 to 3.0% in FY2015/16 and 2.7% in the budget for FY2016/17. Pricing reforms being responsible for about one-third of the decline in subsidies between FY2014 and 16.

Fiscal savings from the energy subsidy reforms were redirected towards social spending, namely health and education, which, in FY2015, outstripped spending on energy subsidies for the first time.

The engagement on energy subsidy reforms opened doors for broader

reform dialogue laying the groundwork for programmatic dialogue that led the Government of Egypt to request for a three-year, multi-billion, multi-donor Development Policy Loan series, which have been partly completed. Energy subsidy reforms being both important prior action, trigger, and target of this Development Policy Financing. Financed in parallel by the African Development Bank (AfDB) and the Agence Française de Développement (AFD), this loan program prepared the groundwork for a three-year, US$12 billion International Monetary Fund (IMF) program, featuring energy subsidy reform as a main pillar, which was approved a year later.

Looking Forward

The Government of Egypt will need to continue reforms while sustaining buy-in to fulfil its targets and commitments to the international community. Major pricing reforms are still needed, even as the population faces economic pressure from price inflation and slow wage growth.

Egypt needs to strengthen and consolidate its social safety net system, in particular, the targeting, communication, and roll out of smart cards. The existing programs have had many weaknesses, including fragmentation and poor coordination; low coverage of the poor; poor targeting performance; and low poverty impact. Egypt's non-subsidy social safety net system has also been among the least generous in the world, amounting to only about 10% of the poorest quintile's consumption expenditure (prior to the increase in 2013). Strengthening public transportation and promoting fuel switching are other key mitigation measures.

Egypt's subsidy reform efforts face further challenges given the recent floating of the Egyptian Pound, which introduced significant exchange rate volatility and led to a major devaluation in November 2016. In order to keep the subsidy reform program on track to achieve its target of 0.5% of GDP by FY2018/19, the Government is planning to move to more frequent adjustments of fuel and electricity prices to counterbalance external factors.

Next Steps

During next phase of technical assistance planned for 2017-19, the World Bank's engagement will focus on building technical readiness for price indexation, including design and implementation support for both fuel price and electricity tariff indexation mechanisms, and fostering coordination between the Energy and Social Ministries.

Technical assistance will be provided on strengthening fiscal reporting and budgetary projections of net fiscal impacts of energy subsidies. Additional support for strategic communication, and synchronizing social protection program reforms with subsidy reforms through inter-ministerial coordination are also planned.

Technical assistance to the social ministries will focus on mitigation and improving social safety nets by developing a unified registry to integrate existing databases, such as the food ration program database with that of the traffic office, pension fund, utility billing, vehicle registration, etc.

Conclusion

With energy subsidies on a long-term growth trajectory, reform was urgently needed. The World Bank's timely assistance provided the tools and models to project the impacts of the reform, convincing the government that energy sector reform could be achieved in a socially responsible manner.

Additional reform will be challenging as future oil price declines are unlikely. Comprehensive, sustained, and socially responsible reform will depend on inter-ministerial coordination. Further technical assistance will be needed to help the government implement its ambitious plan.

[1] Aggregate energy sector recovery cost weighted by cost
[2] For a range of octanes
[3] Over 90% of the gasoline subsidies went to the richest 20% of the population.

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About ESMAP

The Energy Sector Management Assistance Program (ESMAP) is a global knowledge and technical assistance program administered by the World Bank. It provides analytical and advisory services to low- and middle-income countries to increase their know-how and institutional capacity to achieve environmentally sustainable energy solutions for poverty reduction and economic growth. ESMAP is funded by Australia, Austria, Denmark, the European Commission, Finland, France, Germany, Iceland, Japan, Lithuania, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as the World Bank.