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The Social Contract Undermined through Economic Reforms: the End of an Era for the Egyptian Middle Classes

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Summary

- The socioeconomic benefits enjoyed by the middle classes have historically been one of the Egyptian state's main pillars of legitimacy and characteristic of a welfare state that has existed since the postcolonial era of the 1950's.
- Since the uprising of 2011 (the so-called "Arab Spring"), the Egyptian economy has suffered from recession, inflation, and widening budget deficits.
- In August 2016, the government accepted an IMF loan and embarked upon a program of substantial economic reforms.
- These reforms have undermined (and continue to undermine) the social contract that has been in place since the 1950's and leave a significant section of the Egyptian population struggling under tougher economic conditions.
- New policies are directed primarily at the poorest sections of society and include a phasing out of food and energy subsidies
- Organized mobilization against the new socioeconomic order has largely failed, but spontaneous protests against tough economic conditions are seemingly becoming more frequent.

Since the accession of Abdelfattah al-Sisi to power, the Egyptian government has been carrying out a series of reforms to enhance economic performance and facilitate growth. Despite these measures, the Egyptian economy continues to struggle. A deepening recession, widening state deficits, depletion of foreign reserves and a decline in trade are only a few elements of the gathering crisis. As a last resort, in August 2016 the Egyptian government reached an agreement with the International Monetary Fund over a three year plan to inject 12 billion US dollars into the economy and to implement a program of economic adjustment. This program includes a gradual phasing out of food and energy subsidies, a downsizing of the public sector, and a free floating of the Egyptian Pound. In fact, the package of reforms has entailed severe consequences for the Egyptian economy. The floating of the Egyptian pound in November 2016 caused a spike in inflation, a shortage of commodities and medication, and the withdrawal of several local and foreign investors. Indeed, it is expected that the impact on Egyptians will only become harsher in the coming years, with new austerity measures incorporated from the beginning of the 2016/2017 fiscal year and slated to continue over the coming years. Aside from their severe social and economic consequences, these new policies seem to comprise a significant alteration of the traditional role of the Egyptian State and constitute a clear challenge to the social contract that has existed since 1952.[1] Middle-income groups were at the core of the previous framework, but they now face a dual challenge: they are gradually excluded from socioeconomic benefits they have enjoyed for over six decades, and inflation and recession makes it harder for them to recover from the expected consequences of the reforms for their incomes.

Economic performance and the struggle for legitimacy

The welfare state in Egypt was established during the 1950s and 1960's to facilitate Egypt's postcolonial "nation-building", which was one of the Gamal Abdel Nasser's most prominent political objectives. The intended beneficiaries of the new framework were employees of the public sector and workers in state owned factories, who collectively constituted Egypt's so-called "urban middle class". A system of insurance, as well as subsidies for universal health care, education, public sector employment, food, energy, and transport, were established primarily to serve this group. Consequently, an extensive welfare state was created to cater to an income group, which, for more than three decades, relied almost entirely on the state for its livelihood, with the regime expecting political support and obedience in return. Taken together, this constituted a new social contract in which socioeconomic privileges were granted in exchange for political legitimacy, and it constituted an essential component of Nasser's legitimacy after Egypt's independence in 1954, remaining largely intact under successive regimes, despite domestic political and economic challenges. However, the January 2011 uprising – in which the urban middle classes played a key role – was indicative of the weakening of this social contract, which to some extent had ceased to fulfil its original purpose.

In the wake of the political turmoil of 2011, the Egyptian economy has faced three major challenges that have led to the current situation in which reform is costly yet inevitable. Firstly, there is an evident balance of payments problem coupled with a shortage of foreign exchange and low reserves. Secondly, there is a high budget deficit of about 12% of GDP, and rising debt equal to about 95% of GDP. Thirdly, low growth of about 2% over the last five years, and a high unemployment rate of 12.7%, represent long-term structural problems.

Al-Sisi, despite his apparent lack of a clear electoral program, was widely perceived as Egypt's savior from both political and economic crisis and was elected in June 2014 by a majority of voters. Two key mobilizing factors tapped into by al-Sisi in his bid for power were, first, the political instability that followed the 2011 uprising and, second, economic challenges that reached their peak during the presidency of Mohamed Mursi (2012-2013). The former general's electoral campaign adopted a progressive discourse which promised to "restore the glory of Egypt", meaning that economic recovery comprises a vital dimension in his struggle for legitimacy. On the one hand, there is a perception that the regime's political rivals fear economic recovery might increase al-Sisi's popularity and enable him to tighten his grip on power.[2] On the other, the government and pro-regime sections of the media accuse opponents – particularly the Muslim Brotherhood and their allies – of trying to topple the government, whether through direct action (such as terrorist attacks) or through the fomenting of a "negative atmosphere" by, for example, spreading rumors of an economic crisis.

Against the background of this struggle for economic recovery and political stability, al-Sisi's administration has been carrying out a series of legislative reforms to enhance economic performance, attract foreign investors and re-invigorate growth. 2014 saw the announcement of the New Suez Canal project, which involves the establishment of a logistics complex in the area around a new maritime passage and promises to increase foreign reserves and employment. In March 2015, an international economic conference was held at Sharm-El-Sheikh, a center of Egyptian tourism, on sustainable economic growth and attraction of foreign investment. This conference was marked by a number of announcements regarding new projects in infrastructure, energy and real estate, as well as the establishment of a new administrative capital. New incentives for investors in sectors of the economy considered to be of national priority and export-oriented activities, efficient taxation policies and enhanced investor-government dispute settlement mechanisms were also introduced.

Despite these measures, however, the Egyptian economy did not significantly improve. Modest growth, increased inflation and a widening budget deficit were coupled with a further depletion of foreign reserves, which in March 2016 reached the critical level of 3.5 months of imports coverage.[3] The Central Bank of Egypt proved unable to maintain the exchange rate at 6.7 EGP/US$ and, in the third quarter of the 2015/2016 fiscal year, embarked upon a series of local currency devaluations. The situation further deteriorated with an increased tightening of access to foreign currency, restrictions on imports, and on capital repatriation for foreign investors, which forced many to exit the market. Meanwhile, speculations further brought the exchange rate to unexpectedly high levels on the parallel (black) market. A severe crisis seemed likely.

In August 2016, the Egyptian government finally announced an agreement with the IMF to obtain a three-year extended fund facility of 12 billion US$. It is expected that the IMF loan will enable Egypt to increase its foreign reserves while implementing a comprehensive policy reform package to promote sustainable and job-rich growth, improve the functioning of foreign exchange markets, and reduce continuous budget deficits. The economic reform package also provides for a free floating of the exchange rate which is intended to trigger a depreciation of the EGP, increase exports' competitiveness and attract tourism and foreign investment. This is expected to foster job creation, economic growth, and adjust the country's external deficit. Furthermore, the government intends to press ahead with cutbacks in fuel and food subsidies, as well as public sector employment[4]. Savings from these cutbacks, as well as increased revenue from revised tax policies, haves been earmarked for investment in health, education and the enhancement of economic growth. By adjusting energy prices to their market value, the fuel subsidy reform is also expected to increase the attractiveness of investment in labor-intensive activities, thereby contributing to higher job creation. As a result of this package of tax and expenditure policies, government debt is expected to decline from about 98% of GDP in 2015/16 to about 88% of GDP in 2018/19.[5]

In preparation for the first loan installment in November 2016, the Central Bank of Egypt floated the Egyptian Pound, causing a severe depreciation that by January 2017 had hit 20EGP/US$. The consequences were painful: increased prices, shortages of imported products and medication, and further withdrawals by firms and investors. By March 2017, the annual official inflation rate announced by the Central Bank of Egypt had reached 32.25%[6] and, with the beginning of a new fiscal year in July 2017, fuel subsidies were cut, leading to an average fuel price increase of 45%. As of August 2017, electricity prices are expected to increase due to further subsidy reductions.

"Targeting the poor": a new policy orientation

The policies introduced since al-Sisi's accession to power and accelerated by the IMF loan/reform package have had a highly variegated impact on different income groups. The policies seem to be paving the way for a framework in which the state restricts itself to supporting the "poor". This is reflected in newly introduced programs which are largely based on the concept of "targeting" and aim at a gradual replacement of the previous system in which public resources were heavily allocated towards universal subsidies. With the exception of health and education (both guaranteed under the Egyptian constitution), all other policy components are being revised in order to "protect the vulnerable" and "break the poverty cycle". According to the government-IMF agreement, budgetary savings resulting from cuts and an eventual phasing out of energy subsidies will be partially spent on enhanced social protection (including targeted food subsidies and new cash transfer programs), as well as on longer-term investment in health and education to tackle intergenerational poverty. This process has already been set in motion, with food subsidy coverage increased in November 2016 from 18 EGP to 21 EGP (approximately 1,17 $[7]) per person and a further increase expected in the Fiscal Year 2017/2018. More importantly, two recently introduced social protection programs – *Takaful* and *Karama* – mark the new policy orientation in Egypt. Takaful (*solidarity*) is a conditional cash transfer program which provides monthly revenue to families with children, subject to attendance at school and mandatory health checkups, while Karama (*dignity)* is designed to assist the elderly poor and people with special needs who are unable to work. The Takaful and Karama programs are planned to reach 1.7 million households and 7.3 million beneficiaries, covering the entire area of Upper Egypt, in addition to pockets of poverty in Cairo and several northern cities.

Losers from the new framework: the "middle-class", the "rich" and the "business elite"

While these policy reforms appear to favor the "poor", the privileges of other income groups have been substantially eroded – especially those of the "urban-middle class", the main stakeholder of the welfare state for the past 60 years. The current government apparently has no intention of giving significant economic benefits to the middle class: subsidies are being phased-out, while taxes on earnings and consumption are increasing. Furthermore, a new Civil Service Law, recently ratified by the Parliament, is expected to reduce the size of the state bureaucracy through the application of strict performance evaluation measures and promotion criteria. The share of public administration revenues in public expenditure is expected to drop below the current 25% in order to provide further budgetary savings.

Maintaining the support of the middle classes was the priority for all of Egypt's previous regimes. The size and importance of these groups are by no means negligible; civil servants currently account for at least 7 million employees, which is equal to 30% of total formal sector employment in the Egyptian economy. Successive governments have been forced to court the politically influential civil service through the granting of financial and non-financial benefits. Under Hosni Mubarak's rule, civil servants were compensated for their extremely low basic salaries with an increase in other benefits, such as "variable payment", limited working hours and extended maternity or family leave, which (unofficially) allowed many to work informally in order to increase their revenue. However, such benefits did not protect all of the middle classes from gradually slipping into poverty, with low quality social services, higher prices, corruption and political repression helping to explain why a growing proportion of this group joined socioeconomic protests even before the January uprising.[8]

It is expected that further economic reform, by taking away most of the formerly-guaranteed privileges of middle-income groups, will prove extremely painful for this section of the population. Moreover, an ongoing recession and inflation massively complicates the middle classes' struggle to maintain their living standards, with many confronted by the very real prospect of poverty.

One exception to this grim picture is the predicament of those who earn minimum and maximum wages. In response to the demands of lower and middle ranking civil servants, a minimum monthly salary of 1,200 EGP (approximately 67 US$) as well as a maximum monthly salary of 42,000 EGP (approximately 2,300 US$), were introduced at the beginning of the 2014/2015 Fiscal Year. Minimum and maximum wages reflect a modest effort on the part of the state to maintain its legitimacy among civil servants by showing a concern for social justice, which was one of the main components of the January 2011 uprising and previous social movements. However, fixing a maximum wage was met with considerable resistance from higher-income groups in state-owned sectors, such as energy and public banks, as well as among top officials in several ministries,

including the Ministry of the Interior.[9]
The economic reform package requires not only cutbacks in public expenditure, but also an increase in public revenue. Consequently, the new framework is also costly for the upper-middle and upper-income groups in Egypt, particularly due to the introduction of new taxes which target property and increased taxes on income. In this context, since the Fiscal Year 2014/2015, a real estate tax has been in force which is expected to have a negative impact on wealth accumulated by upper-middle income households. The stated aim is to use the real estate tax to fund the improvement of informal settlements around Cairo and other large cities.
Another prominent loser from al-Sisi's economic reforms is the "business elite". Since the mid-1990s, Egyptian businessmen enjoyed privileged access to resources, tax exemptions and other incentives offered by the state, and were also increasingly prominent in the previously ruling National Democratic Party (NDP), as well as in the Parliament and the Cabinet. By refusing to invest in the economy, and by using the media they owned against the Muslim Brotherhood, business also played a key role in the ousting of Mohamed Mursi, and it was also part of the broad coalition that supported al-Sisi's rise to power. However, the new administration seems to be losing the backing of business, for a number of reasons. First, recent years have seen an unusual expansion and diversification of the economic activity of the armed forces.[10] The Egyptian Army has played a role in the economy since the 1970s, with successive governments awarding the Ministry of Defense several contracts for carrying out infrastructure projects through direct orders (i.e., without public tenders).[11] In the past, however, the private sector largely coexisted with what is often called the military's "economic empire", with both parties adhering to a clear division of tasks. Sectors such as heavy industry, tourism and telecommunications were monopolized by big businesses,[12] while the military involved itself in agrarian projects, land reclamation, civilian public works contracts, construction, maritime transport, production of petrochemicals, and environmental projects. However, since July 2013, the Armed Forces Engineering Authority has been entering new sectors previously controlled by large local businesses such as food and media production and civil construction, which has sometimes resulted in the exclusion of businesses from important areas of economic activity.[13] Furthermore, massive projects carried out by the Army have subcontracted the private sector, which has resulted in the military wielding supervisory power over its business partners.
The business elite has also lost many of its once-guaranteed financial privileges and is now faced with increased revenue taxes, a new tax on capital gains, and a temporary tax on income exceeding 1 million EGP (approximately 55000$). Energy-intensive industries such as cement, fertilizers, iron, steel and ceramics have also suffered from cutbacks in energy subsidies. The private sector thus finds itself to some extent excluded or, at least, underprivileged, and certainly under pressure from the increasing demands to donate heavily to secure the health of the Egyptian economy. [14]

Breaking the social contract

The core of the social contract in Egypt remained largely unchanged between the January 2011 uprising and al-Sisi's assumption of power in 2014. In fact, between 2011 and 2014, pensions more than doubled, public sector employment and salaries increased, and public works programs were implemented as a short-term remedy to poverty. In 2016, however, economic performance hit extremely low levels and the government found itself obliged to accept drastic and painful economic reforms as a condition for obtaining the three installments of the IMF loan – the last resort before economic collapse. However, these reforms are significant not only in their consequences, but also because they reflect an explicit redefinition of the state's relationship to its citizens and challenge the core of a social contract that has endured for some sixty years. Indeed, social groups that once benefited are now required to "tighten their belts" and to "give more" to Egypt. This poses a serious threat to the legitimacy of al-Sisi's regime – especially amidst massive spending cutbacks on subsidies, social transfers and public sector employment representing nearly 60% of total public expenditure. Social protection is now aimed only at those most at risk; food subsidy beneficiaries are continuously reassessed; energy subsidies are phased-out; and employment opportunities are restricted. While new policies are designed to focus on the vulnerable, broad sections of the middle classes risk falling into poverty. In this way, reform jeopardizes the historical pact between the state and the middle class which lay at the core of the welfare state between 1952 and 2014, and which ensured the stability of successive governments. Al-Sisi's measures thus represent a challenge to the existing social contract and eliminate many socio-economic benefits to an extent that no previous president would have contemplated.[15]

Outlook

Achieving economic recovery is a critical aspect of the current regime's drive for legitimacy. However, the current reforms imply a clear breach of the pre-existing social contract, and thus carry possible political risks. They also come at a cost for all income groups in Egypt. In the meantime, the anticipated benefits of these reforms have thus far remained elusive. For example, while state and IMF officials emphasize the role of depreciation in increasing competitiveness and creating more jobs, concrete policies do not appear to be encouraging growth in the private sector – especially not in labor-intensive sectors. This can be inferred from the obvious tendency to favor massive projects as a means of ensuring success and restoring credibility, and from the recent expansion of the military's role in the market. Many fear this new economic setup, and others argue that, over the long-term, it is unviable; the private sector is likely to regain its prominence, given its importance to the state as a source of investment and tax revenue, as well as its perceived significance as the key to economic growth and therefore to the regime's legitimacy and stability.[16]

The policy reforms accompanying the IMF loan are expected to have a significant impact on different income groups in Egypt. These reforms are said to be indispensable, given the current economic context. Nonetheless, these reforms are painful, given the conspicuous lack of accompanying measures to protect those damaged by them. The government did attempt to reduce the costs of the reforms, but only modestly and to no great effect. The prospect of a medium- to long term improvement is uncertain, if not entirely absent. For example, in order to protect the poor from the effects of inflation, food subsidy coverage was increased – modestly in the Fiscal Year 2016/2017, and most likely further in 2017/2018. Yet, with galloping inflation, increased food subsidy coverage would probably entail little more than a price-effect without resulting in a better quality or larger quantity of subsidized commodities. The same is true of minimum wage regulations that were introduced to respond to popular demands but failed to reflect a real increase in purchasing power. Furthermore, minimum wages have been introduced only for public sector employees and are of little benefit to that significant proportion of Egypt's labor force that is employed in the informal sector without either a stable revenue or access to social protection schemes. High-middle to higher income groups also face inflation, recession and higher taxes. As for the business elite, a few tax reforms have been postponed in order to encourage production, but overall they are still subject to higher taxes and fewer energy subsidies, and they must now accept a new imbalance in the market, where the military is increasingly given to intervention.

Alongside their socio-economic impact, the political consequences of reform are also critical, though to some extent these too remain uncertain. It could be that the reform policies are paving the way

for a new social contract which aims at "*upholding political Nasserism but ignoring economic Nasserism. [...] A right-wing form of Nasserism.*"[17] However, the state's removal of economic privileges while continuing to expect the concession of political rights does not seem to be a viable long-term option. The consequences of the new framework are thus difficult to divine. Al-Sisi's ability to carry out painful reforms without causing much upheaval does not necessarily indicate popular support for his policies, while the rather tepid resonance of organized protest[18] might indicate either a high level of repression and intimidation, or a fear of deeper misery. Egyptians are also aware of the instrumentalisation of their grievances in an ongoing political struggle between al-Sisi and his opponents in the Muslim Brotherhood – a struggle they are largely indifferent to. Significantly, those protests that have proven successful generally arose spontaneously and in response to purely economic issues, such as increasing prices or shortages of critical supplies (subsidized infant milk formula, for example, or basic commodities).
Economic deterioration might normally be expected to destabilize the regime, but it could also act as a source of stability if people fear the worst or lose hope entirely. Indeed, a popular mobilization against the regime currently seems unlikely. Unfortunately, increased social violence and crime could provide an alternative response to the tougher living conditions brought about by the reforms.

[1] The definition of the "social contract" is restricted in this analysis to social and economic benefits provided by political regimes in exchange for public support and as the main source of legitimacy. For more details, see Al-Awadi, Hesham (2004): In Pursuit of Legitimacy: The Muslim Brothers and Mubarak, 1982-2000. London: Tauris Acad. Studies (p.10-13).

[2] Adly, Amr (2015): Economic Recovery in Egypt Won't Guarantee Political Stability. In: Carnegie Middle East Center. Retrieved from: http://carnegie-mec.org/2015/05/20/economic-recovery-in-egypt-won-t-guarantee-political-stability-pub-60113

[3] Central Bank of Egypt (November 2016): Monthly Bulletin.

[4] Remuneration of public sector employees and subsidies represents nearly 60% of total public expenditure.

[5] International Monetary Fund (2017): Online press briefing on the release of the Staff Report on Egypt's request for an IMF Extended Fund Facility. Retrieved from: https://www.imf.org/en/News/Articles/2017/01/18/tr01182017-Transcript-Online-press-briefing-on-the-release-of-release-of-the-Staff-Report-on-Egypt.

[6] Central Bank of Egypt (March 2017): Consumer Price Index Press Release.

[7] Average exchange rate in May 2017 is 18 EGP/US$.

[8] Nearly one third of labor protests in 2007 and 2008 were undertaken by civil servants.

[9] Adly, Amr (2014): The Sisi Government's Attempts to Win Over Egypt's Civil Servants. In: Carnegie Middle East Center. Retrieved from: http://carnegie-mec.org/2014/08/27/sisi-government-s-attempts-to-win-over-egypt-s-civil-servants-pub-56462

[10] For more details see: Chams El-Dine, Chérine (2014): Fragile Alliances in Egypt's Post-Revolutionary Order. The Military and Its Partners. In: SWP Comments 46. Retrieved from: https://www.swp-berlin.org/fileadmin/contents/products/comments/2014C46_chams_el_dine.pdf

[11] According to Chérine Chams El-Dine, "*State officials justify their preference for the Armed Forces Engineering Authority over private companies on the basis of the army engineering authority's rapidity in implementing projects for the lowest cost and with the highest quality*." Ibid.

[12] Ibid.

[13] Important activities include low-income housing units for low income groups, maintenance of bridges and highways, and the development of informal settlements.

[14] A national fund 306306 (in reference to June 30th) was created after the removal of Mursi for collecting donations to salvage the Egyptian economy. After al-Sisi rose to power in June 2014, another fund named *Tahya Masr* (Long Live Egypt) was established. Al-Sisi requires the private sector to contribute to national development and social projects through this fund.

[15] The exception here is Sadat's decision to introduce "minor" reforms to the food subsidy system which increased prices of food products in January 1977. This decision resulted into country-wide riots and strikes, and was canceled 48 hours later.

[16] For more details see: Adly, Amr (2014): The Future of Big Business in the New Egypt. In: Carnegie Middle East Center. Retrieved from: http://carnegieendowment.org/files/big_business_egypt.pdf.

[17] Ramadan, Fatima; Adly, Amr (2015): Low-cost Authoritarianism. The Egyptian Regime And Labor Movement Since 2013. In: Carnegie Middle East Center. Retrieved from: http://carnegieendowment.org/files/CMEC_56_Ramadan-Adly_Authoritarianism.pdf

[18] For instance, "Al- Ghalaba" (Poor People's) Movement, was a Facebook initiative seeking to mobilize protest against al-Sisi on November 11th, 2016 – the day of the IMF loan approval.

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