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U.S. Economic Aid to Egypt: Designing a New, Pro-Growth Package

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This is the first in a two-part series on the topic "U.S. Aid to Egypt: Building a Partnership for the 21st Century." Read Part II.

For the first time in nearly twenty years, the United States will soon revamp foreign aid to Israel and Egypt. Given the centrality of these programs to overall spending for international assistance, this is an important moment. And because these structural overhauls occur so rarely, it is likely that the contours, if not the details, of new aid packages will survive for years to come.

The modern era of aid to Israel and Egypt was born following the October 1973 war and came of age with the huge sums committed in the wake of the 1978 Camp David Accords. The current levels of assistance -- to Israel, $3 billion per year ($1.8 billion for military, $1.2 billion for economic); to Egypt, $2.1 billion per year ($1.3 billion for military, $815 million for economic) -- have varied only occasionally since 1980.

For several months, Washington and Jerusalem have been negotiating the details of the new U.S.-Israel assistance package but the outlines have been clear for some time. Over the next decade, Israel's allocation of "economic support funds" will be phased out completely, with half of those savings added to Israel's allocation of military assistance. The future shape of the aid package -- zero economic aid, 50 percent more military aid -- reflects Israel's changed circumstances. Not too long ago, Israel was shackled with a third-world, socialist-style economy; it can now boast a hi-tech, first-world economy whose gross domestic product, nearing $17,000 per capita, places it on par with moderately wealthy European countries. At the same time, however, Israel is beset by more complex and dangerous military challenges than ever before, i.e., the still-live potential for war with bordering states combined with the threat of long-range ballistic missiles tipped with weapons of mass destruction.

With Egypt, neither the strategic analysis for a new aid package nor its details has been worked out; the only certainty is that pressing needs for funds to support a wide variety of U.S. global interests will result in an overall decrease of U.S. aid to Egypt. In contrast to Israel, Egypt does not face any significant military challenges, yet the Egyptian military's role as the paramount source of regime stability remains intact. While Cairo has publicly criticized many U.S. diplomatic initiatives in the region, it has resolutely provided the United States with necessary access and transit for U.S. forces whenever U.S. strategic interests were at stake. Although the Egypt-Israel peace remains frigid, Egypt's implementation of the security aspects of the treaty has been excellent. Economically, Egypt has made great strides in reforming the structural impediments to growth. However, Egyptian economic reform remains a sisyphian task, with huge advances needed for the country to continue advancing upwards out of poverty and unemployment.

Through it all, the basic rationale for supporting Egypt and strengthening the strategic partnership remains unchanged -- to cement Egypt-Israel peace, the cornerstone of all peacemaking efforts; to assist the Egyptian regime in its battle against religious extremism for the hearts and minds of the Egyptian people; and to secure Egypt as a positive model of a pro-West, pro-peace, status quo power to the states and peoples of the Arab and Islamic worlds.

Against this background, the present two-part series will examine U.S. interests in Egypt and the principles that should undergird the provision of U.S. assistance. Today's installment discusses economic aid; tomorrow's will address military aid.

Background Egypt's economy has scored impressive improvements over the past decade. While still grappling with huge problems, Egypt today has the potential to compete in the global, free-market economy of the 21st century. The two-decade old U.S. assistance package, heavily weighted toward project funding from the Agency for International Development, helped improved Egypt's tattered infrastructure, but it is now obsolete. Washington now has the opportunity to trim down and re-fashion its aid program with an eye toward promoting Egyptian exports, making Egypt more attractive for foreign investors, and assisting Egypt's transition to a free-market economy -- all goals that would strengthen the U.S.-Egypt partnership and advance U.S. interests.

Aid History U.S. assistance to Egypt (and to Israel) blossomed in the wake of the 1978 Camp David Accords. For Egypt, this aid was essential in countering the inter-Arab isolation and the beleaguered popular mood it suffered for Anwar Sadat's strategic decision for peace. Economically, the assistance ($815 million economic; $1.3 billion military) was badly needed: Egypt's balance of payments was hemorrhaging, forcing borrowing that drove the country's foreign debt up from $7 billion in 1976 to $21 billion in 1980. The magnitude of the aid was itself quite large, equal to 10 percent of gross national product -- the equivalent of $750 billion for the 1998 U.S. economy -- paid on an annual basis. In retrospect, the aid was an excellent example of an effective use of foreign assistance, cementing Egypt's new strategic relationship with the United States, providing an important incentive to keeping the peace treaty alive during moments of stress (e.g., the 1982 Lebanon War), and eventually moving Egypt along the path of vital economic reform.

Two decades after Camp David, much has changed to make aid less important. First, Egypt is doing well economically, with no net foreign debt (foreign debt is less than foreign reserves, a situation helped by Washington's Gulf War write-off of $6.7 billion of military debt), 6 percent annual real growth, and a per capita income ($1,280 in 1997) high enough to put Egypt in the World Bank's middle-income category. To the surprise of many observers, Cairo has actually taken great strides toward implementing a broad array of economic reforms. Second, Egypt no longer suffers diplomatically for its peace with Israel. Cairo faced the Arab world squarely in the eye over its peace treaty and forced the latter to blink. While one can justly criticize the warmth of Egypt-Israel peace, Cairo kept its promise not to buckle to Arab criticism, sanctions or ostracism; Egypt's peace with Israel is a fact of life that all other Arab leaders now accept de facto. Third, and perhaps most important, U.S. economic assistance to Israel is being phased out. Against this background, the original logic of substantial U.S. economic assistance to Egypt clearly no longer applies.

When combined with the intense need to find funds to pay for other international programs, these factors have generated a wide consensus in policy and legislative circles to take advantage of the phase-out of Israel's economic aid to re-think Egypt's aid program, too. However, a phase-out of Egypt's economic aid, along the lines of Israel's, would be inappropriate. Economic reform in Egypt is an unfinished project. Despite its recent progress, Egypt still faces huge obstacles to growth, ranging from the nearly 1 million new entrants to the job market each year to the slow pace of privatization and the still-suffocating power of the state bureaucracy. Egypt will continue to need substantial U.S. assistance to ensure the success of its reform effort and the overall importance of the strategic partnership makes investing in Egypt's economic health a vital U.S. interest. Washington therefore should take the opportunity to re-fashion its assistance program in such a way as to provide a smaller, leaner package that emphasizes aid and trade, lowers the profile of U.S. donors (the AID mission is the largest in the world), invigorates the reform program, encourages Egyptian export industries, and makes Egypt a more appealing place for foreign investment. The following principles would govern the new package:

1) Decrease economic aid by half, from $815 million to $407.5 million, phased in over a five-year period. Ten percent of the current level ($81.5 million) would be cut each year.

2) No new project commitments. Zeroing out future AID project commitments will send foreign investors a strong political message about Egypt's economic maturity. Currently, there is a $1.6 billion "pipeline" of undisbursed development project aid. This backlog is equal to 4.5 years annual spending, meaning that even if no funds were committed to new projects, disbursements would continue at close to present levels for two-to-three years and then taper off for another four-to-five years.

3) Divide the remaining aid among three programs: "commodity import program (CIP);" cash transfer; and "export enhancement initiatives."

- CIP: For years, Congress has mandated this program at $200 million per year, all of which finances imports by the Egyptian private sector of U.S. equipment and material. Economists generally regard this as an inefficient way to transfer cash to the Egyptian government, because of the contradictory mix of too much paperwork providing too little protection against allegations of corruption by local middle-men. On the other hand, U.S. suppliers like a program which makes U.S. goods more competitive relative to European goods. Maintaining this program is a political necessity.
- Cash transfer: Cash assistance has been effective at promoting economic reform by tying cash payouts to reform measures. While much progress has been made on the reform program, much remains to be done, as illustrated by the failure to take measures that would secure release of $555 million in cash aid committed but not yet disbursed (i.e., also in the "pipeline"). The cash component of aid is arguably the element most appreciated by the Egyptian government, if for no other reason than because less of it is diverted into meeting the extraordinarily detailed bureaucratic requirements of the U.S. aid program.
- Export Enhancement: This is the major innovation in the aid program and would include funding for ideas such as bilateral research and development endowments; industrial investment funds to promote foreign investment; creation of "qualified industrial zones" joining Egypt and other peace process states; support for an export promotion agency; funding for training and educational programs with U.S. firms and industries, etc.

By this formula, the two accounts that most directly channel money to Egypt (CIP and cash transfer) would actually show an increase in the first year. In future years, cuts do not have to come equally from the three accounts, giving flexibility to show that the CIP and cash transfer accounts remain near or even above current levels for much, if not all, of the down-sizing period.

4) Commit the United States to negotiate and implement a U.S.-Egypt Free Trade Agreement. In the beginning, discussions should focus on increasing Egyptian access to U.S. markets. Washington should promise to begin implementing an FTA by the end of the five-year phase-in period.

5) No change in the level of U.S. military aid to Egypt during the five-year period. (For further details, see Part II of

this PolicyWatch.)

Conclusion While this proposal halves Egypt's economic assistance, it changes the mix in a way that offers Egypt substantial advantages over the current package: an increase in direct cash transfer, a commitment to a Free Trade Area, and a full-scale U.S. effort to remake Egypt into an export-driven economy. Movement in this direction is essential both to ensure that Egypt's notable economic achievements reach fruition and to place the bilateral strategic relationship on firmer footing.

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