Persistent unemployment represents a direct threat for economic and social stability of any country that, in turn, hinders its human and economic development. The economic literature provides strong evidence that unemployment increases the risk of poverty and contributes to inequality. With the exception of the high-income Gulf countries, the Middle East and North Africa (MENA) region has experienced one of the highest unemployment rates in the world. Egypt’s double-digit unemployment is distressing as the average unemployment rate was 11.5% during the last 10 years. Therefore, governments strive to reduce unemployment rates and mitigate its impacts by means of fiscal policy.

From a theoretical point of view, the role of government in the economy was debatable. The Keynesian economists claim that an expansionary fiscal policy stimulates aggregate demand leading to an increase in employment. In contrast, the neoclassical theories argue that fiscal contractions make room for an expansion of the private sector and thus, have a stimulating effect on the economy.

Empirical studies lack consistent findings concerning the employment effect of government expenditure. Some studies found that increasing government expenditure reduces unemployment (Maku & Alimi (2018); Holden & Sparrman (2016) and Matsumae & Hasumi (2016)). Another group of studies concluded either a worsening or an insignificant effect (AL-Saraireh (2014) and Abubakar (2016)). A third group of studies found that various types of government expenditure can have mixed effect (Onodugo et al. (2017) and Murwirapachen (2013)). Empirical studies concerning Egypt lack analyzing the important link between government expenditure and unemployment rate.

Therefore, the objective of this research is to empirically examine whether the increase in government expenditure was able to reduce the unemployment rate in Egypt and if so, to what extent. One of the novelties of this research is that it distinguishes between discretionary and non-discretionary items of government expenditure. This distinction seems important since aggregate government expenditure typically includes interest expenditure that can barely be adjusted by policymakers in the short-run (exogenous from the government’s perspective) and consequently, can be considered non-discretionary.

This paper will test two basic hypotheses; first; whether the aggregate government expenditure can reduce the unemployment rate, second; whether discretionary expenditures have the same effect. With respect to Egypt, several studies highlighted the poor performance of government expenditure. Slimane (2012) showed that the positive shocks to government spending
caused crowding-out of private investment. In the same vein, Elbaz (2014) noticed that during the last decade, the efficiency of aggregate government expenditure tended to decline. Moreover, Elnashar (2017) concluded that Egypt’s spending multiplier has been low, indicating a relatively weak impact of government spending on real GDP throughout the last decade. Consequently, government expenditure is expected either to have a worsening or an insignificant effect on the unemployment rate.

The empirical analysis will cover the period 1980-2017, going through the following steps: First, the Augmented Dickey Fuller (ADF) test is conducted in order to examine the stationarity of data. Second, Johansen cointegration test is employed to ensure the existence of a long-run relationship among variables. Third, to estimate the long-run and short-run dynamic relationship between government expenditure and unemployment, the Vector Error Correction Model (VECM) is used. Finally, the impulse response analysis and variance decomposition are performed to respectively examine the impact of government expenditure on the unemployment rate. The findings of this model will help to provide an evidence to guide policy-makers to a better understanding of how to address the unemployment problem. The paper is structured as follows; the first section gives an overview of the trend and composition of government expenditure in Egypt. The literature review is given in the second section and the third section includes the empirical model. The fourth section summarizes the study results and suggests some policy recommendations.