المركز المصري للدراسات الاقتصادية
ECES
The Egyptian Center for Economic Studies

POLICY VIEWPOINT

Number 4 **November 1998**

Towards A Value-Added Tax in Egypt*

Policy Viewpoint is devoted to the discussion of ideas and policy options for enhancing economic development in Egypt. The series is based on research conducted by ECES. The content and recommendations are endorsed by the Center s Board of Directors.

The worldwide use of value-added taxation is changing the way countries formulate their tax policies and administer their tax systems. The shift from partial turnover taxes to value-added taxes (VATs) has proved to generate more revenue and contribute to greater flexibility with fewer economic distortions.

This issue of *Policy Viewpoint* makes the case for reforming the general sales tax (GST) in Egypt. The suggested reform should broaden the taxable base, generalize the tax credit and rationalize the rate structure by limiting it to two positive rates. This will bring the GST closer to a viable VAT. By analyzing the recent tax reforms in Egypt and comparing the tax system to that of the Mediterranean countries participating in the Free Trade Association Agreements with the European Union (EU) and that of the members of the Association of South East Asian Nations (ASEAN), it becomes apparent that Egypt has much to gain by reforming the GST on the basis of VAT principles *(see table 1)*.

Sales taxes, which are sometimes, referred to as taxes on consumption, include, inter alia, turnover taxes, purchase taxes and VATs. All of these taxes are levied on the consumption of goods and services. The main differences between them are related to the coverage of the aggregate base, stages at which the tax may be levied, the accumulation of tax incidence, and the double taxation of inputs used in producing taxable goods and services.

Value-added taxes offer the following advantages over other forms of consumption taxes: (a) they are neutral because they avoid double taxation through the credit mechanism – the most important feature; (b) they have a relatively broad base because they are usually levied on all stages in the production and distribution process; (c) they relieve instruments and savings from the burden of taxes on goods and services; (d) because of their broad aggregate base, they generate adequate revenue with relatively low rates and therefore encourage taxpayers' compliance; and (e) they exempt exports completely from taxes as goods and ser vices through the zero-rating mechanism.

The Egyptian GST is similar to the VAT because it allows for crediting taxes paid at an earlier stage against the tax to be paid. The GST differs, however, from a VAT in having a narrow base which excludes the distribution sector; a limited tax credit which does not cover capital goods, services, and goods subject to excise duties (commodities included in Table 1 of the GST Law No. 11/91); and selective taxation of services instead of taxing all services other than those explicitly exempt. The suggested reform, based on the principles of VAT, can be introduced within the framework of the current GST in Egypt. Some countries tax goods and services through a broad-based consumption tax-type VAT. Because of historical developments or mere preferences, they use the terminology 'goods and services tax'as is the case in Canada. These taxes are identical to VAT in their incidence and coverage, but are given different names.

Recent Tax Reforms

A number of comprehensive tax reforms were introduced in Egypt between 1986 and 1996. These reforms supported the macroeconomic efforts to accelerate economic development and sustain financial stability. Three key tax reforms were adopted: (1) the 1986 tariff reform, which continues to provide the structure of taxation for imports, but with more transparency and fewer low rates; (2) the 1991 reform of taxes on goods and services, which introduced the principle of general taxation of goods and services; and (3) the 1993 reform of taxes on income and profits, which replaced the scheduler and general income taxes with a global income tax to improve incentives to invest and work.

These reforms have had a far reaching impact; they improved the revenue productivity of the tax system, simplified its structure, and reinforced its administration. Yet these reforms must be strengthened and revised in light of subsequent events. The improvement in taxes on income and profits, as measured by the large share of their revenue, should not disguise the fact that a significant share of revenue is contributed by the three major public enterprises – oil, the Suez Canal, and the Central Bank. This revenue depends primarily on sources that are neither stable nor sustainable. In addition, the global income tax, despite its progressive rates and the significant improvement in the economy, generated the lowest share of tax revenue (0.7 percent of GDP) compared to many countries included in this study, and registered a buoyancy lower than unity.

Drawbacks of the GST

The 1991 GST is increasingly becoming an important pillar of the Egyptian tax system, especially as the forthcoming Free Trade Association Agreements with the EU will require eliminating customs duties and other taxes having the same effects on imports of EU origin. The actual experience of the last seven years shows improvement in revenue productivity, reduced economic distortions and cumulative burdens, and reinforcement of the administration of taxes on goods and services.

The GST, however, bears the following defects:

1) A narrow basis, since it remains limited to manufactured goods, imports and selected services. Equally important is the selective taxation of services, which must be generalized and extended to all services other than those explicitly exempt.

2) Although the rate structure of the GST was partially rationalized following consolidation of the highest two rates into one, it needs further rationalizing and limiting of the positive (non-zero) rates to no more than two.

3) Absence of a special law for excises, which is unique to Egypt.

4) Lack of generalized credit for the GST paid at earlier stages, since all services, capital goods, and excisable goods do not benefit from the credit.

Converting the GST into a VAT would likely have little price effect, since the bulk of goods and imports are already taxed under the GST. Moreover, Law No. 11/91 stipulates in its first article the extension of the GST to the stages of the wholesaler and retailer. The expected improvement in efficiency and revenue from adopting a VAT will not necessarily result in an unfavorable distributional impact. On the contrary, the generalization of services taxation should be seen as a way to remove loopholes and improve the distribution of the tax burden, since services are usually consumed by those in high-income brackets. In order to convert the GST to a VAT successfully, some reforms are necessary.

Recommended Reforms

Broaden the Base of the VAT

In taxing the distribution sector, the proposed VAT should not make a distinction between wholesalers and retailers. The experiences of other countries suggest that this distinction does not lend itself to effective application. The vast majority of countries apply VAT at multiple stages, including retailers, through a threshold (registration exemption).

A meaningful threshold is central to VAT. It should be high enough to exclude the many small taxpayers whose taxes would not cover the cost of their registration, control of declarations, and refunding credits. Initially, the threshold could be set at £E200,000 instead of the current threshold of £E65,000.

The new threshold should be the same for all taxpayers who provide services or sell goods that are subject to the excise duties (table 1 of the law).

Generalize the Tax Credit

The input credit should be generalized and should cover the entire amount of the VAT paid in the earlier process of production and distribution. The current practice discriminates against capital-intensive industries and creates problems by treating the tax on the purchase of capital goods as depreciation over a period of 5 or 10 years. Many countries, after lengthy debate, credit the full VAT on capital equipment with no differentiation.

Rationalize the Rate and Improve Tax Administration Efficiency

The higher rate of 25 percent and the standard rate of 10 percent should be consolidated into a new rate of 12 to 15 percent. This will simplify administration, rationalize the rate structure, and possibly increase revenue to compensate for revenue lost following the generalization of the tax credit. Eliminating the highest rate should not raise concern about reducing rate differentiation and the possibility of regressively adding to taxation of goods and services. Experiences of other countries confirm that rate differentiation, in particular higher rates, has little impact, if any, on the distribution of the tax burden. In 1992, all member countries in the Organization

Table 1. Current Rates of Value-Added Taxes in Mediterranean Countries Associated with the EU and Members of ASEAN

Country	Date Introduced	Reduced Normal Rate	High Rate	Rate
Mediterranean Counties				
Egypt	July 1991	5	10	25
Algeria	April 1992	7	13	21
Cyprus	July 1992	8	8	8
Israel	July 1976	6.5	17	—
Lebanon	—	—	—	—
Malta	July 1992	15	15	15
Morocco	April 1986	7	14	21
Jordan	June 1994	5	10	20
Syria	—	—	—	—
Tunisia	July 1985	6	17	29
Turkey	January 1985	1&8	15	23
ASEAN Countries				
Korea	July 1977	10	10	10
Indonesia	April 1985	10	20	35
Malaysia	February 1972	5	10	—
Philippines	January 1988	10	10	10
Singapore	April 1994	3	3	3
Thailand	July1992	7	7	7

Source: Based on tax laws of individual countries.

for Economic Cooperation and Development (OECD), with the exception of Turkey, eliminated increased rates and limited the number of VAT rates to not more than two. Four out of six member countries of ASEAN apply a single tax rate. This confirms the insignificance of rate differentiation as a means of improving the distribution of the tax burden.

Taxation of Services

The selective method of taxing services should be generalized. The positive list of taxable services should be replaced with a negative list of exempt services, and all other services should be taxed.

The cumulative incidence of the GST on services should be removed, and all tax activities liable to the GST should benefit from the tax credit *(see table 2).*

Taxation of Excises under the VAT

Some excise duties are based on rates that date back to 1981 when the consumption tax came into effect. Excise duties should be curtailed and limited to goods for which a strong case can be made for a significantly higher rate than the VAT, such as tobacco, petroleum products, alcoholic beverages and passenger cars. Other currently excisable goods should be taxed under the reduced or normal VAT rates.

Goods that will remain liable to excises could be taxed at different rates (ad valorem and/or combined rates) depending on the amount of revenue to be generated from each commodity and on the price charged to the final consumer.

Excise duties, despite the suggestion to curtail them, are expected to have an important role in view of future reductions in top tariff rates. To compensate for revenue loss in import duties, new excises could be introduced, rather than the current practice of having additions on top of the GST rates (Presidential Decree 65/95 and Law No. 2/97). This practice is in conflict with rate rationalization and the goal of limiting the positive rates to not more than two. Currently, the de facto number of rates exceeds the suggested number of two.

Stamp duties, especially on services that will be taxed following the generalization of the service tax, should be reduced to lower the combined burden on these services.

Distributional Consequences of the Shift to VAT

The impact of these reforms on the distribution of the tax burden must also be considered in view of equity as a goal of tax policy. Critics claim that VAT tends to discriminate against low-income groups by taxing consumption rather than income received or earned. Income in its traditional sense, however, is not always the best indicator of ability to pay. Expenditure and consumption are now

Table 2. Egypt: Positive List of Taxable Services and Proposed Negative List of Exemptions[1]

Positive List	Negative List
Hotels and tourist restaurants	Medical and dental care
Tourist transportation services	Postal service
Telex and facsimile services	Financial services (core and secondary)[2]
Air-conditioned means of transportation	Insurance and reinsurance
Sound and light show services	Activities of nonprofit organizations
Use of sound and light company's utilities	Cultural and educational services
Art agent's service in public and private parties	Radio, television, theater, cinema (not including advertising)
Local telephone, telegraph services	Foreign exchange services
International communication services	Lotteries
Telephone installation and connection services	Renting immovable properties
Employment contracts	
Car rental services	
Express mail services	
Maintenance and security services	
Public road services (tolls, etc.)	
Brokerage services for real estate	
Brokers' services for car sales	

[1] There is no worldwide standard list for exempt services, since it varies from one country to another. This list is for illustrative purposes.

[2] Core financial services include dealings in money, shares, bonds, lending money, advancing credit and operating bank accounts. Secondary financial services include financial advice, debt collecting, keeping securities, etc.

Source: Based on Law No. 11/91.

widely considered to be more indicative of the consumers' benefit from goods and services, and therefore their ability to pay.

If adopted, the value-added will be fairly proportional to the expenditures of different categories of taxpayers, regardless of their 'income'. Possible negative distribution effects will be mitigated by exemptions for basic goods and services and by extending taxation of services usually consumed by those in high-income brackets. In addition, public services, financed through broadbased taxes, are more beneficial to low-income groups currently exempt from individual income taxes, due to the high threshold of exemption.

Recommendations

The essential recommendation of this *Policy Viewpoint* is to convert the Egyptian GST into a true VAT by broadening the aggregate base, rationalizing the rate structure, generalizing the tax credit, and integrating taxation of services with taxation of goods. The reform should be comprehensive and structural, not ad hoc like the changes introduced over the last seven years. Converting the GST into a viable VAT in Egypt is a logical evolution of recent reforms and reflects the global trend towards value-added taxation as the most productive revenue generator with the least economic distortions. This conversion should not in itself increase the burden on the tax administration or the cost of taxpayers' compliance.

*For more details on this issue review ECES Working Paper number 22.

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