Egypt's General Sales Tax:
Recent Developments and Reforms Ahead

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Abstract

This paper analyzes the Egyptian General Sales Tax (GST) which has registered a high buoyancy over the last six years, while income taxes on individuals are showing declining buoyancy despite progressive rates. This paper recommends replacing the GST with a value-added tax (VAT) to increase efficiency and revenue productivity. The GST must be reformed by broadening the aggregate base through taxation of all goods and services, generalizing the tax credit to cover tax paid earlier, adjusting the threshold to reflect the administration's ability to cope with increased taxpayers, rationalizing the rate structure, and replacing the positive list of taxable services with a negative list of specified exemptions. Replacing the GST with a VAT should not increase the administrative burden. The tax burden is not expected to be adversely affected, because it is independent of the number of stages at which the VAT may be levied. In addition, the VAT, as a tax on income expended, or rather on consumption of goods and services, can be considered a norm of the ability to pay.

ملخص

تحلل الدراسة إمكانية إحلال ضريبة القيمة المضافة محل الضريبة العامة على المبيعات المطبقة حاليا فى مصر خاصة فى ظل الزيادة فى الأهمية النسبية للضريبة العامة على المبيعات كأحد المصادر الرئيسية للإيرادات الضريبية.

وتوصى الدراسة بالانتقال إلى ضريبة القيمة المضافة. ولكى تحقق هذه الضريبة أغراضها المرجوة من وفرة فى الحصيلة، وإنتاجية فعالة فى الإدارة الضريبية وكفاية اقتصادية عالية، فإنه ينبغى تعديل الضريبة على المبيعات تعديلا من شأنه أن يحقق الآتى: (١) توسيع القاعدة الضريبية والأخذ بمبدأ عمومية الضريبة؛ (٢) تعميم خصم الضريبة المدفوعة عند مراحل سابقة من الضريبة المستحقة؛ (٣) تعديل حد التسجيل لكى يعكس قدرة الإدارة الضريبية على مواجهة الزيادة فى عدد الممولين؛ (٤) ترشيد فئات الضريبة؛ (٥) وضع قائمة سلبية للخدمات المعفاة بدلا من القائمة الإيجابية.

وخلصت الدراسة إلى أن الأخذ بضريبة القيمة المضافة لن يؤدى فى حد ذاته إلى زيادة ملموسة فى الأعبـــاء الملقاة على عاتق الإدارة الضريبية أو إلى توزيع غير عادل للعبء الكلى للضرائب وخصوصا بعد أن أصبح الدخل المنفق على السلع والخدمات يلاقى قبولا متزايدا كمعيار للمقدرة على الدفع.

I. Introduction and Scope of the Study

This study evaluates Egypt's General Sales Tax (GST), which came into effect in 1991, replacing the Consumption Tax of 1981. This paper compares the structure of the general sales tax in Egypt with those of the Mediterranean countries associated with the European Union (EU) and the member countries of the Association of Southeast Asian Nations (ASEAN). Finally, the paper makes recommendations for moving from GST to a value-added tax (VAT).

Despite limited data, useful conclusions are reached about Egypt's principal tax problems and the effects of the structural tax reforms introduced to date. The study suggests means that could deepen the reforms of the last decade and situate reforms yet to be introduced. However, the focus is on VAT, which is at the top of the authorities' agenda.

The paper is organized as follows. Section 2 reviews recent developments in Egyptian tax policy and the increasing revenue role of the GST. Section 3 analyzes the GST revenue in more detail and discusses the main features of the proposed VAT. Section 4 offers a summary of principal conclusions and recommendations.

II. Tax Structure and Recent Developments

Until the mid-1980s, the Egyptian economy was beset by major weaknesses that prevented adjustment to changing conditions and policies. The economy was highly controlled, as the major share of industries was state-owned and the prices of many important products were controlled by the government. The country's debt-to-GDP ratio was one of the highest in the world, and the consolidated budget deficit reached about 22 percent of GDP. The exchange rate system was dominated by multiple rates, with a considerable gap between the commercial bank exchange rates and the customs rate used to determine the dutiable value of imports in Egyptian pounds. The combination of these factors led to low growth, inflationary pressures, balance of payments difficulties, a relatively low tax ratio and growing budget deficits.

Although Egypt's Open Door Policy was declared in 1974, for years it was not supported by appropriate tax reforms. The tax system was characterized by excessively high nominal rates on individual income and profits, high tariffs to protect import-substitute industries, and extensive customs and tax exemptions for consumer goods.[١]

Tax Reforms of 1986-1996

During the past decade, Egypt's fiscal policy makers recognized the need for comprehensive reform of the tax system and introduced reforms covering virtually all

[١] For more details, see A.M. Abdel-Rahman, "The Egyptian Income Tax Reform: Toward a Unitary Income Tax," *l'Egypte Contemporaine*, pages 69, 373, 163-94, 1978.

duties and taxes on imports, goods and services, and income and profits. These reforms were meant to:

- reinforce the ongoing efforts to achieve development and stability;
- support new economic policies, in line with the Open Door Policy, to encourage private investment and foreign capital;
- encourage liberalization of the economy, improve incentives and conditions for private savings and investment, and reduce the need for tax exemptions from the unreasonably high tax and tariff rates of the early 1980s.

Beginning in the early 1990s, several significant improvements on the macroeconomic front took place. The budget deficit for 1991/92 dropped to about 7 percent of GDP, the exchange rates were unified eliminating the gap between the customs rate and the commercial bank rate, and the balance of payments turned from deficit to surplus. The improved balance of payments and unification of the exchange rate encouraged the authorities to reform the tax system. Significant tariff reform was adopted in 1986, and in 1991 the general sales tax was enacted.[٢] Continued economic improvement led to the 1993 reform of taxes on income and profits, which removed excessively high marginal rates and reduced the number of taxable brackets.

Notwithstanding these reforms of the tax system, further reforms are needed. The expected loss of revenue from customs duty, as a result of trade liberalization in the context of an agreement with the EU, calls for reform of the tariff to reflect:

- the reduction in tariff rates on goods originating in the EU;
- minimization of origin as a factor affecting imports from outside the EU;

[٢] Before the 1986 reform, taxation of imports was characterized by the following:
i. Multiple duties and taxes levied on the same products adding anomalies in the treatment of the same good under the different duties. The principal supplementary duties included development taxes, statistical duties, municipality tax, maritime duty, etc. This multiplicity reduced transparency and complicated administration.
ii. Excessive rates— reaching as many as 50 rates, ranging from zero to 3,000 percent—resulting in insignificant differentiation and sometimes in negative protection.
iii. A wide gap between commercial bank rates and the customs rate used to calculate duty in Egyptian pounds. The customs rate was quite appreciated compared to the market rate. It dated back to 1979, remaining unchanged until 1986. The gap between the rates significantly eroded the aggregate basis of dutiable goods and distorted foreign trade statistics.
iv. Extensive exemptions that used to be granted outside the tariff by separate laws and decrees and quite often without consultation with the Ministry of Finance. It was estimated that exemption amounted to about 40% of total imports. The proliferation of exemption contributed to more negative protection for some industries. Some finished goods were exempt while raw materials and other inputs in their production were taxed.
v. The provisional admission procedures were widely practiced and about 20 percent of total imports left customs without being completely examined or assessed. This resulted in considerable revenue loss and administrative difficulties. For more details see A.M. Abdel-Rahman, "The Egyptian Tax System: Recent Developments of Tax Policy and Administration," in *Tax Systems in North Africa and European Countries* (Kluwer, 1994).

- further tariff rationalization by lowering the maximum tariff rate to no more than 40 percent and reducing the number of tariff bands to no more than five; and
- instituting a viable minimum tariff rate levied on all imports irrespective of their origin (including those from the EU)[٣].

The 1993 reform of taxes on income also needs revision to equally tax income from different sources, further reduce the number of brackets and lower the top marginal rates. Finally, despite economic expansion and increased affluence, the individual income tax is declining in relative importance and showing a buoyancy ratio lower than unity. Corporate tax rates should be further reduced to no more than 35 percent to minimize the need for exemptions.

In exploring the reform possibilities of the GST, it is useful to look at international experience. The next section analyzes the status of tax revenue in Egypt and then compares its structure with those members of ASEAN and several Mediterranean countries associated with the EU.

Tax Revenue in Egypt and Some CountryComparisons

Analysis of recent tax revenue developments is subject to limitations that must be considered in assessing the country's taxable capacity and utilization. For example, data incorporated in Tables 1, 2 and 3 are limited to tax revenue of the central government. Therefore taxes collected by local governments, mainly on buildings and agricultural land, are not included. Tax components that may be incorporated in fees and prices of public goods are also not accounted for because of the difficulty quantifying them. Social security contributions by both employers and employees are not treated as central government tax revenue despite their importance. Central government tax revenue represents about 40 percent of total government revenue and therefore evaluating the country's tax ratio; the size of public sector and its financing could be misleading unless the entire revenue is considered. The substantial gap between tax revenue and total revenue may be explained by the still important share of public enterprise profits to the central government.

[٣] Following the association with the EU, Egypt and the USA are negotiating a free trade area that most likely will exempt imports from the USA from 'cutoms duties' and other charges having the same effect Under these conditions, about 70 to 80 percent of imports will be exempt from 'cutoms duties' and, therefore, the suggested minimum tariff rate should gain in importance and should be levied on all imports regardless of their origin. This would represent a major step towards minimizing the origin of imports and should facilitate a simplified tariff structure with fewer and lower rates on all imports and no particular preferences.

Tables 1, 2 and 3 show tax revenue by major tax categories and their relative importance to total tax revenue and gross national product. Taxes on income and profits ranged from a high of 8.3 percent of GDP in 1992/93 to a low of 6.3 percent in 1990/91. Corporate taxes contributed the principal share of this revenue due to the scope of oil revenue, the Suez Canal and the Central Bank of Egypt. Individual income tax, despite its progressive rates, registered a decline, from 1.49 percent of GDP in 1990/91 to 0.70 percent in 1995/96.

Table 1. Egypt: Tax Revenue by Principal Categories, 1990/91-1995/96 [1] (millions LE)

	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96
Taxes on income and profits	6,219	11,530	13,059	14,504	15,034	16,790
Individual income taxes	1,471	910	1,037	1,342	1,361	1,558
Corporate taxes	4,748	10,620	12,022	13,162	13,673	15,232
Business profits tax	3,939	9,086	10,077	10,661	10,773	12,149
Corporate distribution	809	1,534	1,945	2,501	2,900	3,083
Other direct taxes	148	4	8	12	21	24
Taxes on goods and services	4,649	8,163	9,258	10,737	12,207	13,524
General sales tax	3,272	6,324	7,191	8,080	9,333	10,450
Stamp duties	1,377	1,839	2,067	2,657	2,874	3,074
Taxes on international trade	3,266	4,588	5,009	6,120	7,017	7,911
Customs import duties	3,266	4,588	5,009	6,120	7,017	7,911
Export taxes	--	--	--	--	--	--
Total tax revenue	14,282	24,285	27,334	31,373	34,279	38,249
Gross domestic product	118,272	139,100	157,083	173,117	200,408	223,966

1. Data limited to tax revenue collected by the central government. Local taxes and social security are not included. The fiscal year ends June 30.

Source: Based on data provided by the Ministry of Finance.

Table 2. Tax Revenue by Principal Categories, 1990/91-1995/96 [1] (% total tax revenue)

	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96
Taxes on income and profits	43.54	47.48	47.78	46.23	43.86	43.90
Individual income taxes	10.30	3.75	3.79	4.28	3.97	4.07
Corporate taxes	33.24	43.73	43.98	41.95	39.89	39.82
Business profits tax	27.58	37.41	36.87	33.98	31.43	31.76
Corporate distributions	5.66	6.32	7.12	7.97	8.46	8.06
Other direct taxes	1.04	0.02	0.03	0.04	0.06	0.06
Taxes on goods and services	32.55	33.61	33.87	34.22	35.61	35.36
General sales tax	22.91	26.04	26.31	25.75	27.23	27.32
Stamp duties	0.64	7.57	7.56	8.47	8.38	8.04
Taxes on international trade	22.87	18.89	18.33	19.51	20.47	20.68
Customs import duties	22.87	18.89	18.33	19.51	20.47	20.68
Export taxes	0	0	0	0	0	0
Total tax revenue	100	100	100	100	100	100

1. Data limited to tax revenue collected by the central government. Local and social security taxes are not included. The fiscal year ends June 30.

Source: Based on data provided by the Ministry of Finance.

Table 3. Egypt: Tax Revenue by Principal Categories, 1990/91-1995/96[1] (% GDP)

	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96
Taxes on income and profits	6.30	8.29	8.31	8.38	7.50	7.50
Individual income taxes	1.49	0.65	0.66	0.78	0.68	0.70
Corporate taxes	4.81	7.63	7.65	7.60	6.82	6.80
Business profits tax	3.99	6.53	6.42	6.16	5.38	5.42
Corporate distributions	0.82	1.10	1.24	1.44	1.45	1.38
Other direct taxes	0.15	0.00	0.01	0.01	0.01	0.01
Taxes on goods and services	4.71	5.87	5.89	6.20	6.09	6.04
General sales tax	3.32	4.55	4.58	4.67	4.66	4.67
Stamp duties	1.40	1.32	1.32	1.53	1.43	1.37
Taxes on international trade	3.31	3.30	3.19	3.54	3.50	3.53
Customs import duties	3.31	3.30	3.19	3.54	3.50	3.53
Export taxes	0	0	0	0	0	0
Total tax revenue	14.48	17.46	17.40	18.12	17.10	17.08

1. Data limited to tax revenue collected by the central government. Local and social security taxes are not included. The fiscal year ends June 30.

Source: Based on data provided by the Ministry of Finance.

Buoyancy (the relation between the percentage changes of revenue and GDP) of corporate taxes showed improvement in the last six years, reflecting the Tax Department's effort to terminate backlog. Thus a good share of revenue includes, inter alia, assessment made for prior years, and the increase in tax revenue from the three major public enterprises. In this period, the buoyancy of corporate tax, despite the proportional rate, exceeded that of progressive individual income tax (Table 4).

Taxes on goods and services are becoming an important source of revenue yielding about 6.1 percent of GDP in 1995/96. This reflects the favorable effect of the GST. Although still limited, the tax has, to some extent, broadened the aggregate base of goods and services, enforced their administration and paved the way for a GST based on the principles of value-added taxation. Revenue from these taxes includes, *inter alia*, revenue from stamp duties, which is collected mostly from transactions usually taxed as services. Revenue from traditionally excisable goods is included in this category; as Egypt has no special law for excises, these are taxed within the GST.

Table 4. Egypt: Buoyancy of Tax Revenue with Respect to GDP Growth 1990/91-1995/96
(percent of total tax revenue)

	Tax Revenue Growth 1990/1-1995/96	GDP Buoyancy[1] Index
Taxes on income and profits	2.70	1.19
Individual income taxes	1.06	0.47
Corporate taxes	3.21	1.41
Business profits tax	3.08	1.36
Corporate distributions	3.81	1.68
Other direct taxes	0.16	0.07
Taxes on goods and services	2.91	1.28
General sales tax	3.19	1.41
Stamp duties	2.23	0.98
Taxes on international trade	2.42	1.07
Customs import duties	2.42	1.07
Export taxes	0.00	0.00
Total tax revenue	2.68	1.18
Gross domestic product	2.27	1.00

1. Data limited to tax revenue collected by the central government. Local and social security taxes are not included. The fiscal year ends June 30.
2. The buoyancy is measured as the relation between the percentage change of revenue and the percentage change of GDP. A distinction, however, must be made between buoyancy and elasticity of revenue as the latter gives an accurate idea of the responsiveness of different taxes to changes in GDP. The elasticity has to be measured after eliminating or adjusting for the revenue effects resulting from discretionary tax measures. Because of data constraints, it was not feasible to estimate the elasticity.

Source: Based on data provided by the Ministry of Finance.

Revenue from duties and taxes on imports increased from LE 3,266 million in 1990/91 to LE 7,911 million in 1995/96 with an increase in the tax to GDP ratio from 3.3 percent to 3.5 percent. This increase took place despite the reduction of top tariff rates and the average tariff to promote exports and create a neutral incentive system to guide resource allocation among import substitutes. The increase in the share from import duties reflects the impact of minimum tariff rates levied on almost all imports. At the beginning of the 1980s, revenue from import duties exceeded that from taxes on goods and services, but recently this situation has been reversed. Revenue from taxes on goods and services (6.7 percent of GDP) far exceeds that from duties and taxes on imports, which produce only 3.8 percent.

Taxes on goods and services are increasingly becoming the principal source of tax revenue from both locally-produced goods and imports, while import duties are becoming limited to the role of protection. Accordingly, import duties are expected to produce a relatively important but declining share of revenue in the years ahead. This is a desirable shift in the allocation of tax policy instruments to their respective goals, which should be pursued further. Policy goals are achieved when each policy instrument is assigned a specific goal. Tariffs tend to be efficient when limited to protection, while general sales taxes become productive when they are assigned the role of revenue. Table 5 summarizes the current use of different tax policy instruments and their respective policy goals compared with proposed allocation to enhance the efficiency of tax policy.

Table 5. Current and Proposed Allocation of Policy Instruments to Respective Goals

Policy Instruments	Objectives under the current system			Proposed objectives of policy instruments		
	Protection	*Revenue*	*Distribution*	*Protection*	*Revenue*	*Distribution*
Tariffs [1]	Yes	Yes	Yes	Yes	No	No
Excises [2]	No	Yes	Yes	No	Yes	Yes
General sales tax [3]	No	Yes	Yes	No	Yes	No
Stamp duties	Yes	Yes	Yes	*To be eliminated and consolidated in principal duties and taxes.*		
Individual income taxes	No	Yes	Yes	--	Yes	Yes

1. Though protection is their primary objective, tariffs also generate revenue as high rates are sometimes levied solely for revenue purposes. Luxury goods are also subject to high rates for distributional purposes.
2. Most excises are levied on locally-produced goods and the small rate differentiation between locally-produced goods and imports has been eliminated.
3. The GST is becoming more and more oriented toward revenue. Under the old consumption tax rate, differentiation and discrimination were pursued, and the increased rate of 25 percent, despite its limited revenue yield, is mainly for distributional purposes.

Table 6 compares Egypt's tax structure with that of some Mediterranean and Asian countries, based on the most recent comparable data available. Egypt has the second lowest per capita tax ration of the group, but generated a higher tax ratio than Algeria, Singapore, Syria and Turkey. Except for Turkey, Egypt produced the highest share of taxes on income and profits, even when compared to some advanced industrialized countries such as Italy and Spain. Within this category of taxes, Egypt produced the highest share from the corporate sector, reflecting the important contribution made by the oil sector, the Suez Canal, and the Central Bank. In contrast with the high share of revenue generated by corporations, the individual income tax produced the lowest share of total tax revenue (0.7 percent of GDP).

Taxes on goods and services yield about 36 percent of Egypt's tax revenue, lower than that of Algeria (50) percent. Syria produced the smallest share, reflecting the absence of a GST and the predominance of selective excises, usually with specific rates that tend to remain unchanged over a long period. Lebanon does not levy a GST, but policy makers are considering a VAT. Duties and taxes on imports produced about 20 percent of tax revenue, higher than some European countries, such as Cyprus, Greece, Italy, Portugal, and Spain, reflecting the insignificant customs duties incorporated in the common EU external tariff and assigned solely to protection. This suggests that import duties will be of declining relevance once Egypt's association with the EU comes into effect.

The comparison with ASEAN member countries tends to confirm that Egypt continues to raise the smallest share of revenue from individual income tax; and Egypt and Indonesia are among the countries that generate the largest share from corporate tax revenue, due to the importance of oil in both countries. This reveals that, despite the recent increase in revenue from taxes on goods and services, Egypt can generate further increases from this source. It also shows that the majority of ASEAN countries applied a VAT, which replaced the turnover and consumption taxes.

Table 6. Tax Revenue by Principal Categories for Mediterranean Countries Associated with the European Union and Members of ASEAN [1]
(In percent of GDP)

			Taxes on income, profits, capital gains:			Taxes on goods and services:				
	Sample period	*Tax revenue*	*Total*	*Corporate*	*Individual*	*Total*	*General taxes, turnover, VAT*	*Excises*	*Taxes on international trade*	*Other taxes*
Mediterranean Countries										
Egypt [2]	1995/96	17.1	7.5	6.8	0.7	6.0	4.4	1.6	3.5	1.4
Algeria	1995	11.8	2.7	--	1.6	5.1	4.9	--	3.7	0.3
Cyprus	1995	26.5	6.3	1.8	4.1	9.2	5.0	3.1	2.6	2.5
Israel	1995	35.4	15.9	3.1	11.4	13.8	12.0	1.4	0.2	0.2
Lebanon	1995	15.0	2.5	--	--	2.2	--	2.2	8.8	--
Malta	1994	25.6	8.7	3.3	4.7	3.8	0.7	0.9	6.6	0.1
Morocco	1995	22.0	5.8	1.9	2.8	10.9	5.7	5.1	4.3	1.0
Jordan	1995	16.5	3.3	2.0	1.3	7.1	--	5.8	6.1	--
Syria	1994	16.7	4.9	--	--	0.4	--	0.4	3.0	8.4
Turkey	1995	14.2	5.7	1.4	4.3	7.2	4.6	1.5	0.7	0.4
Tunisia [3]	1995	25.1	4.8	--	--	6.9	--	--	7.7	5.7
ASEAN Member Countries										
Korea	1995	17.7	6.4	2.5	3.9	6.5	4.2	2.2	1.3	1.5
Indonesia [4]	1994/95	12.6	7.4	6.1	1.0	4.0	3.3	0.7	0.8	0.4
Malaysia	1995	20.3	9.4	6.5	2.9	6.6	2.3	4.3	3.0	1.2
Philippines	1994	16.0	5.4	2.3	2.2	4.9	1.6	2.3	4.6	1.1
Singapore	1995	16.2	6.6	4.6	2.0	5.7	2.1	0.7	0.7	1.2
Thailand	1995	17.7	6.0	3.9	2.1	7.6	3.5	3.8	3.2	0.1

1. The Association of Southeast Asian Nations (ASEAN) is considered a model of market forces and export-oriented development that is followed by many developing countries. Egypt, Jordan and Malaysia apply general sales tax that are limited to manufacturing, imports and selective services.
2. In Egypt, revenue from taxes on goods and services include 1.3 percent of GDP generated by stamp duties.
3. Including social security contributions.
4. Including oil-gas taxes.

Source: IMF, Government Finance Statistics and country documents

III. Reforms Ahead: From Consumption to General Sales Tax

Although taxes on goods and services came into effect in Egypt in 1921, policy makers did not recognize them as an important source of revenue until recently. A 1930 tariff introduced protection and revenue customs duties, and in 1932 the ad hoc production taxes were codified in a single law. That law continued as the basis for taxing goods and services until the mid-1960s, when Egypt applied a differentiated form of indirect taxes known as price differentials. Until the 1980s, tax policy makers and administrators focused on income, profits and duties, and taxes on imports

In 1981, the many laws and decrees introducing different production taxes, excise duties, and price differentials with their host of modifications were consolidated into the Consumption Tax Law. Regardless of its title, the consumption tax was not a broad-based tax on consumption of goods and services. Although it consolidated the scattered provisions, it carried over the defects accumulated during the previous 50 years. While it was levied on imports and locally produced goods, the rates were not uniform for many goods. To the extent that consumption tax rates on imports exceeded their corresponding rates on domestic production, the consumption tax on imports amounted to an additional import duty. In case the rates of the consumption tax on imports were lower, they reduced the protection of local industries provided by the tariff. The consumption tax was also characterized by a heavy reliance on specific rates. To protect its revenue yield, the rates had to be increased, thus requiring lengthy procedures of legislation and enactment. The 1991 GST reduced these limitations.

A principal feature of Egyptian taxation of goods and services is the wide use of stamp duties levied on heterogeneous groups of transactions that are usually taxed under service taxes. Historically, the use of stamp duties to tax services goes back to the Capitulation that limited the country's jurisdiction over broad-based taxes whether on imports, transactions, income or profits. Because of their relatively broad coverage, stamp duties generated a significant share of revenue that exceeded revenue from individual income taxes. They also registered a high ratio of buoyancy because:

- the rates usually include proportional and progressive elements especially on the transactions related to advertisement, consumption of water and electricity, travel and financial services;
- the base is broad, as no exemptions are granted; and
- the rates were frequently increased in view of the heavy pressures to mobilize additional revenue.

The GST came into effect in 1991 following the enactment of Law No. 11/91. This law is considered the third most far-reaching reform in Egypt's contemporary tax policy and its administration.[٤] The following sections analyze the base of the GST, the

[٤] The other important reforms are: (1) the 1930 tariff reform that provided Egypt with tariff autonomy which was not complete under the capitulation. Before 1930, tariff duties could not encourage and protect local industries. Duties to be levied had to treat imports and their equivalent locally-produced goods equally; and (2) the 1939 taxes on income and profits, which also were not within the Egyptian jurisdiction because resident aliens and foreign corporations were exempt from all direct taxes under Capitulation. With the enactment of the general sales tax, the

revenue generated from the principal components (imports, excises, manufactured goods and services), and the rate structure. This analysis is intended to shed some light on the directions for reforming the GST, with the objective of maximizing simplicity and neutrality and yielding goals. These objectives are attained when the GST is converted into a VAT that provides a uniform taxation of goods and services with a base as general as possible.

There was considerable debate before the enactment of the GST about its coverage, the stage or stages on which it should be levied, taxation of services, and whether the proposed GST should directly reach the distribution sector or should follow the gradual approach used by many countries before instituting a modern value-added tax. In the final analysis, Law No. 11/91 limited the GST to the stage of manufacturers, imports and services, although its first article anticipates the eventual taxation of the stages of wholesalers and retailers.[٥] Article 4 stipulates that the extension of the GST to these stages could be introduced by a presidential decree.

Despite the significant increase in its revenue yield, the GST remains less general than its title may suggest; it is still limited to manufacturing and excludes the distribution sector. Taxation of services remains selective and limited to those services covered in Table 2, including those added by presidential decrees. The credit for tax paid at earlier stages is not complete and far less than general, as capital goods, services and excisable goods are excluded from the credit. Regarding international trade, the GST follows the destination principal according to which goods that are sold are presumed consumed and thus taxed. Imports therefore are taxed but not exports.[٦] Exports benefit from a zero rate on items that enter into their production.

The adoption of a VAT, which can be attained by extending the GST to the distribution sector, would be in accordance with Law No. 11/91. It should offer the opportunity for comprehensive reform needed to complement the seven ad hoc changes introduced over the last six years, which left the GST structure unchanged

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Egyptian tax policy could maximize its goals if each important instrument of this policy is assigned as a specific goal as shown in Table 5. For more details about the impact of the capitulation on Egyptian taxation, see A.M. Abdel-Rahman, “Egyptian Income Taxation of Nonresident Aliens and Foreign Corporations and its Effects on Egyptian Economic Growth,” 1960.

[٥] The GST, by being limited to manufacturers and taxing services selectively and cumulatively, is based on the old French production tax that existed in 1958 before being replaced by the VAT.

[٦] Under the origin, goods are taxed in the country of production; therefore imports are exempt, but exports are taxed.

and the limitations that the experience might have revealed untackled.[٧] The suggested reform based on a value-added tax could achieve the following:

- Improve the economic efficiency of the tax system by removing the current distortions of the GST. These distortions result from having a narrow base limited to a single stage and from a partial tax credit not covering the entire GST paid at earlier stages.
- Increase the revenue yield without additional administrative burden. The General Sales Tax Department was organized with a VAT in mind. With the experience gained over the last six years, the replacement of the GST by a VAT and taxation of the distribution sector should not pose administrative difficulties.

By increasing revenue, the proposed VAT would facilitate the enforcement of urgently needed reforms deferred because of their negative revenue effects. The top marginal rates of the general income tax, corporate profits tax rates, and the top tariff rates, could be lowered further if the resulting revenue loss is compensated for by other tax sources, and the value-added tax is the preferred source.[٨] The proposed reform will also contribute to the administration efficiency of the entire tax system through closer coordination with the business profits tax and the adoption of the national taxpayer identification number system. Moreover, a VAT is needed to meet the revenue impact of the forthcoming association with the EU and the regional economic grouping among Middle Eastern countries.

Revenue Developments

Before elaborating on specific reform recommendations, it is useful first to analyze data on the revenue from the GST. Table 7 illustrates the revenue generated by the three components of the GST. Revenue from excises noted in Table 1 increased from LE 2,815 million in 1991/92 to LE 3,497 million in 1995/96, but declined in relative terms from 44.8 percent to 33.4 percent of GST, or from 2.0 percent to 1.6 percent of GDP, respectively. The decline may be explained by the increase in the importance of other components, mainly services and manufactured goods, and the specific rates

[٧] The *ad hoc* changes were introduced by Presidential decrees No. 180 and 206 of 1991, 77 of 1992, 295 and 304 of 1993, 39 of 1994, 65 of 1995, and 305 of 1996.

[٨] OECD member countries have mobilized more than 50% of the increases in their tax revenue since 1965 through VATs and other consumption duties. These taxes have become the preferred means of increasing tax revenue. Some OECD member countries have either implicitly or explicitly been trying to shift away from relying on income taxes toward consumption taxes. For more details, see “Consumption Tax Trends,” OECD, 1995, page 7.

levied on a number of goods such as tea, sugar, cement, etc. These rates, which date back to 1981, have remained unchanged, and therefore their revenue has been eroded by inflation. This development should underline the need for reforming excise taxation by limiting it to tobacco and cigarettes, petroleum products, and beverages, which generate the sizable share of revenue. These goods could be subject to different *ad valorem* or combined rates depending on the revenue that needs to be generated and/or the final price to be charged to consumers. Alternatively, other goods, such as tea, sugar and cement, can be taxed under the general sales tax by eliminating them from Table 1. This would minimize the need for periodic rate adjustment to reflect the change in prices and would enhance the principle of taxing similar goods equally. For example, coffee is taxed at 5 percent but not tea and sugar.

Table 7. Egypt: Revenue of GST by Principal Components, 1991/92-1995/96 (millions LE)

	1991/92		1992/93		1993/94		1994/95		1995/96	
	Amount	*%*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*
Domestic Transactions	3,731	59.4	4,455	62.3	4,894	60.6	5,552	59.7	6,097	58.2
Excises inc. in Table 1	2,670	42.5	2,893	40.5	3,042	37.6	3,154	33.9	3,270	31.2
Services inc. in Table 2	126	2.0	322	4.5	351	4.3	522	5.6	733	7.0
Manufactured goods	935	14.9	1,240	17.4	1,501	18.6	1,875	20.2	2,093	20.0
Imports	2,547	40.6	2,690	37.7	3,188	30.4	3,752	40.3	4,373	41.8
Excises inc. in Table 1	144	2.3	195	2.7	177	2.2	209	2.2	227	2.2
Manufactured goods	2,403	38.3	2,495	34.9	3,011	37.3	3,543	38.1	4,146	39.6
Total	6,279	100	7,145	100	8,082	100	9,305	100	10,470	100
(In percent of GDP)										
Total		4.5		4.5		4.7		4.6		4.7
Excises inc. in Table 1		2.0		2.0		1.9		1.7		1.6
Services inc. in Table 2		0.1		0.2		0.2		0.3		0.3
Manufactured goods		2.4		2.4		2.6		2.7		2.8

Source: Calculations based on data provided by the General Sales Tax Department.

Despite their significant role in the Egyptian economy, services generated a modest share of revenue amounting to 0.3 percent of GDP in 1995/96. The modest contribution of services reflects their narrow base, as they remain taxed on a selective basis and limited to those services stipulated in Table 2.

Finally, the revenue share generated by imports continues to be significant amounting to 41.8 percent of total tax revenue from GST in 1995/96 compared to 40.6 percent in 1991/92. The importance of this revenue reflects the narrow base of domestic transactions, which remain limited to the manufacturer sector and the selective services. It may also be attributed to including import duties into the base of imports for the GST, as well as taxation of the first sale following importation.

Table 8 illustrates development of the GST rate structure and the revenue generated by each rate. Initially, the GST had two increased rates of 20 and 30 percent reflecting the policy makers' attempt to differentiate the burden according to the necessity of taxed goods. To simplify the rate structure, these increased rates were consolidated into a single rate of 25 percent. It should be noted that the standard rate of 10 percent generated about 93 percent of the GST revenue underlining the insignificant share produced by lower and increased rates that are assigned the role of differentiating the tax burden.

The analysis of the GST and its recent revenue development reveals its limitations and highlights the need for a comprehensive reform. Such a reform should depart from the ad hoc changes that were introduced over the last six years and should be as structural as the GST, compared to the old consumption tax. A comprehensive reform should achieve a desirable balance between the conflicting goals of broadening the base, rationalizing the rate structure, reinforcing the administration, reducing the costs of taxpayers' compliance, improving the distribution of the burden by minimizing the elements of the VAT regressivity, and alleviating the inflationary effects of the VAT itself. Before a decision is reached about transforming the GST into a VAT, these issues should be carefully analyzed to ascertain their probable revenue, price and distributional effects. The statistical data incorporated in the studies may need to be updated. The following analysis discusses the main features of the proposed reforms.

Table 8. Egypt: Revenue from the General Sales Tax by Rates, 1991/92-1995/96 (millions LE)

Rate	*5*		*10*		*15* [1]		*20* [2]		*25* [2]		*30* [2]		*Total Revenue*	
Year	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
1991/92	63.43	1.90	3,077.71	92.20	--	--	183.59	5.50	--	--	13.35	0.40	3,338.08	100.00
1992/93	70.96	1.90	3,443.56	92.20	--	--	205.42	5.50	--	--	14.94	0.40	3,734.88	100.00
1993/94	217.08	4.80	3,979.80	88.00	--	--	--	--	325.63	7.20	--	--	4,522.51	100.00
1994/95	136.03	2.50	5,049.49	92.80	5.44	0.10	--	--	250.30	4.60	--	--	5,441.26	100.00
1995/96	156.00	2.50	5,790.59	92.80	1.24	0.02	--	--	282.03	4.52	--	--	6,239.86	100.00

1. According to Presidential Decree No. 65/95, the standard rate of 10% as levied on motor vehicles used to transport goods and persons has been subject to an additional 5% resulting in a combined rate of 15%.
2. According to Presidential Decree No. 295 of 1993, the rates 20 percent and 30 percent were eliminated and replaced by the rate 25 percent.

Source: Based on data provided by the Department of General Sales Tax.

Broadening the Base of the VAT

The VAT should be extended to the distribution sector by taxing all suppliers of goods and services whose turnover exceeds the new threshold. It should dispense with the categories of wholesalers and retailers as criteria for taxable events. These concepts do not lend themselves to effective application, and virtually all VATs are levied on a multi-stage basis. The advantages of these criteria could be easily attained through a generous threshold adjusted to take into account the tax administration ability and taxpayer compliance. The experience of many countries illustrates the administrative difficulties confronted in applying the criteria of wholesalers and retailers, which was replaced by the threshold as the criteria in determining taxpayers' obligations to register. This method (threshold) has already been accepted by Law No. 11/91, which limits taxpayers' liability to those having a turnover of LE 54,000 or more. This current level must be adjusted to reflect the shift from the production to the distribution stage.

Closely related to the breadth of the base are the size of exemptions and the coverage of zero-rating. The shift to a VAT should not in itself alter the size of exemption as included in Table 1 of the Presidential Decree No. 180/91. The exemption covers essential goods that are usually consumed by low-income individuals. They include 18 items, such as vegetable oil for cooking, flour, bread, dairy products, books and newspapers. No data are available about the size of these exemptions or their revenue costs, but VATs around the world allow exemptions of essential goods and services to varying degrees. These exemptions are usually determined according to the social, political and economic goals of each country.

According to Article 7 of Law No. 11/91, the zero rate is limited to export activities and is not expected to be modified in connection with the shift to a VAT. The distinction must be kept between zero rating and outright exemption. Zero rating aims primarily at the removal of the entire burden of a VAT from exports. In addition to the exemption of exports from the VAT, zero rating allows a credit for the VAT that might have been charged to inputs used in the processes of producing exports.[٩]

Virtually, all countries limit zero rating to export activities, although a few extend zero rates to consumer expenditure on essential goods and services instead of exempting them or applying reduced rates. It is suggested to continue limiting zero rating to export without being affected with the shift to a VAT. This suggestion is based on the revenue and administration costs of zero rating. For example, in the UK,

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[٩] For a detailed discussion of exemptions in zero rating see, *Value-Added Tax: International Practice and Problems*, Alan A. Tait, 1988, pages 49-79.

where a single rate is in effect, zero rating is extended to a wide range of consumer expenditures on goods and services. According to a 1977 study, it was found that because of the broad use of zero rating, about 30 percent of the 1.25 million taxpayers received refunds and did not contribute to the VAT revenue. It was also estimated then that if zero rating was limited to export activities and replaced by the standard rate, revenue from VAT would have increased by more than 50 percent.[١٠]

Generalizing Tax Credit

The core of the value-added taxation is the credit mechanism that ensures neutrality and economic efficiency. To achieve the maximum of these goals, *credit should be as general as possible and should cover the entire tax paid at earlier stages of production and distribution*.

Under the current practice of the GST, the tax credit is not allowed for capital goods or for services, which continue to be taxed on an accumulative basis. The failure to allow an immediate and complete tax credit on capital goods, could lead to: (1) discrimination against capital-intensive industries, leading some enterprises to postpone the modernization of a plant and equipment; (2) introducing some elements of pyramiding that result from non-crediting the entire amount of the GST. The cumulative effects pyramiding were among the reasons that led to the replacement of the old turnover taxes by the value-added; (3) allowing depreciation for capital goods as a deduction from adjusted gross sales, raises the problem of determining the depreciation period, the method of depreciation, etc.; and (4) the current system could act as a disincentive to exports in economic sectors which are capital intensive compared to other sectors. The availability of zero rate for exports will not remove this disincentive if VAT on capital equipment is creditable only over four to five years.

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[١٠] For more details, see *Review of Value Added Tax*, Report by the Commissioners of Her Majesty's Customs and Excise, London, December 1978, p.8.

11 For example, Hungary, Argentina, and Brazil did not initially extend a complete and immediate credit for the VAT on capital goods. Currently, these countries and many others expand the coverage of the credit to ensure that expenditure on capital goods is free of VAT. For more details see, Occasional Paper No. 88, *Value-Added Tax : Administrative and Policy Issues*, Edited by Alan A. Tait, October 1991, pp.11and 12.

As a remedy to this situation, *the credit should be generalized and available to the entire GST with no distinction between capital equipment and ordinary expenditure*. The revenue cost of generalizing the credit should not preclude its application. Because of these costs, some countries were reluctant to allow credit on capital equipment, but finally recognized the advantages of the credit; this should be the case in Egypt.[١١]

Rate Rationalization

Table 9 gives the rate structure of the GST/VAT for the Mediterranean and ASEAN countries. The comparison reveals that four ASEAN countries out of six apply a single rate (Korea, Philippines, Singapore, and Thailand). This reflects the growing trend toward simplifying the rate structure and minimizing the problems associated with multiple rates, exemptions and special treatment. Malaysia applies two rates assigning the high rate of 10 percent to the sale of goods and the lower rate of 5 percent to services. In effect, goods and services are each subject to single rates.

The table also reveals that no country in the two groups applies more than three rates, but Israel and Malaysia apply two rates. Egypt used to apply four positive rates before the consolidation of the two rates of 20 percent and 30 percent into a single rate of 25 percent. In the last decade, there has been a movement toward reducing the numbers of VAT rates. We can also see that the use ofhigher rates (above the standard rate) has been declining significantly. In 1992, Belgium, France, Greece, Italy and Spain removed higher rates, due to an EU agreement to phase out high rates and simplify the rate structure and, eventually, the administration of VAT. This trend reflects the declining role of increased rates in differentiating the burden of general sales taxes according to the necessity of taxed goods.[١٢]

On the other hand, reduced rates remain popular among policy makers, thus explaining why OECD countries, with the exception of Turkey, currently apply no more than two positive rates. Reducing the number of rates aims at simplifying tax administration and facilitating taxpayer compliance. Egypt eliminated the rate of 30 percent in 1993, in part because of the insignificant revenue yield it generated.

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on capital goods. Currently, these countries and many others expand the coverage of the credit to ensure that expenditure on capital goods is free of VAT. For more details see, Occasional Paper No. 88, *Value-Added Tax : Administrative and Policy Issues*, Edited by Alan A. Tait, October 1991, pp.11and 12.

[١٢] Under the old turnover taxes, many countries had to drop high rates on luxury goods which were in effect for some years, because of their disappointing revenue. For details see, *Sales Tax Administration: Major Structural and Practical Issues with Special Reference to the Needs of Developing Countries*, United Nations, 1976, page 10.

Table 9. Egypt: Current Rates of Value-Added Taxes in Mediterranean Countries Associated with the EU and Member Countries of ASEAN

Country	Date Introduced	Reduced Normal Rate	High Rate	Rate
Mediterranean Countries				
Egypt	July 1991	5	10	25
Algeria	April 1992	7	13	21
Cyprus[2]	July 1992	8	8	8
Israel	July 1976	6.5	17	--
Lebanon[3]	--	--	..	--
Malta[2]	July 1992	15	15	15
Morocco	April 1986	7	14	21
Jordan	June 1994	5	10	20
Syrian	--	--	--	--
Tunisia	July 1985	6	17	29
Turkey	January 1985	1 & 8	15	23
ASEAN Countries				
Korea[2, 5]	July 1977	10	10	10
Indonesia	April 1985	10	20	35
Malaysia[6]	February 1972	5	10	--
Philippines[2]	January 1988	10	10	10
Singapore[2]	April 1994	3	3	3
Thailand[2]	July 1992	7	7	7

1. The Association of Southeast Asian Nations (ASEAN) is considered a model of market forces and export-oriented development that is followed by many developing countries. Egypt, Jordan, and Malaysia apply general sales tax that are limited to manufacturing, imports, and selective services.
2. A single rate is in effect.
3. A VAT extended to all stages is being considered by the authorities.
4. A general sales tax levied on manufacturing, imports and services is being considered by the authorities.
5. Korea applies, in addition to the uniform rate of 10 percent, the used rates for small businesses.
6. Malaysia applies a single rate for the sale of goods and a special rate of 5 percent for services.

Source: Based on tax laws of individual countries.

The tendency to eliminate higher rates should underline that the effectiveness of rate differentiation in influencing the tax burden is quite limited. *The consolidation of the rates, 25 percent and 10 percent, into a single rate of 15 percent, would rationalize further the rate structure, reduce the administrative complexity, and possibly generate additional revenue that could compensate for the revenue loss resulting from generalizing the tax credit on capital goods and services.* Eliminating increased rates in many countries reflects the accepted view that (1) the cost of multiple rates by having increased rates exceeds the benefit to be gained from removing the regressivity, and (2) distributional objectives could be attained with other instruments more effectively, notably with income taxes.[١٣] The Ministry of Finance should assess the probable effects of eliminating the 25 and 10 percent rates and having a standard

[١٣] For more details, see Harry J. Aaron (ed.), *The Value-Added Tax (Lessons from Europe)*, 1981.

rate of 15 percent. The recent experience with rate differentiation and its failure influencing income distribution can be seen as a justification of the consolidation.[١٤]

Improving Tax Administration Efficiency

The success of the shift to a VAT will depend primarily on the ability of the tax administration to cope with the increased number of taxpayers conducting business in the distribution sector and in the number of the stages of the new tax. The willingness of the new taxpayers to comply with their obligations is an equally important factor. It was the authorities' concern about these administrative issues that finally favored the adoption of a GST in 1991 as a first but major step on the road to a VAT.

The shift to a VAT, if carefully designed through a threshold that represents accurately the tax administration ability and taxpayer compliance, should not in itself raise particular problems. On the contrary, according to available statistical studies about the cost of tax administration and taxpayers' compliance, VAT is the cheapest revenue producer. When available, quantitative studies of the cost of tax shed meaningful light on the administration cost. However, these studies are usually subject to a number of limitations that require careful analysis before reaching firm conclusions. According to a 1988 OECD study, it was found that the cost of VAT taxes range from 0.32 percent to 1.09 percent of actual revenue, while taxes on income cost about 2 percent.[١٥] There are some arguments against the criteria based on using the cost of collection as a percentage of revenue. These criteria are seen as an uncertain indicator of efficiency, largely because they are more a reflection of the level of taxation than of administrative costs.[١٦]

Available studies also show that administrative and compliance costs fall considerably when small businesses are excluded from the tax base. This is the function of the threshold, which aims primarily at excluding from the tax registers the many small taxpayers. The share of revenue they usually contribute does not correspond to the costs of their registration, filing returns, controlling collections and issuing refunds.

Table 10 gives the percentage distribution of the GST taxpayers by the size of their turnover. The data confirm that a small percentage of taxpayers in the high-turnover brackets, provide the largest share of the amount of the tax paid. 66 percent of taxpayers fall in the initial bracket of LE54,000 – LE 1,000,000, but their tax amounted to 5 percent of amount of the tax paid. Meanwhile, 3 percent of the taxpayers with a turnover of more than LE 10,000,000, contributed 61 percent of the GST. It would be

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[١٤] In Norway, despite the application of a single rate, a recent interest in differentiating VAT rates emerged; an official commission concluded that a differentiated VAT rate may be an efficient instrument if the group they want to support is a big majority and their consumption pattern is different from the rest of the population. Rate differentiation has not been accepted. For details see, NOU 1993, *Should the VAT be Differentiated?*

[١٥] Organization for Economic Cooperation and Development, "Taxing Consumption," (1988), page 204.

[١٦] See "Review of Value-Added Tax," Report by the Commissioners of Her Majesty's Customs and Excises, London, 1978, page 8.

desirable to have these data completed by showing the distribution of all taxpayers subject to the business profits tax. Such data would be significant in determining the level of the threshold to be introduced. A generous threshold in the range of LE 200,000 – LE 250,000 could be adopted. It can always be changed by a ministerial decree to take into account the changes in the tax administration capacity.

Despite some limitations, the data confirm that a small percentage of taxpayers in the high-turnover brackets have the largest share of turnover and consequently, the amount of the tax paid. The table also shows a significant deviation from similar data about other countries. The data shows that 17.2 percent of taxpayers fall in the initial bracket of less than LE 54,000 but their turnover amounted to 61.9 percent. This anomaly is explained by the fact that taxpayers liable to excise duties (Table 1) are registered irrespective of their turnover, and they fall in this bracket. Data must be scrutinized and completed by having the amount of the paid tax shown. It would also be desirable to have these data completed by showing the distribution of all taxpayers subject to the business profits tax. Such data would be of significant help determining the level of the threshold to be introduced. A generous threshold, in the range of LE 200,000 – LE 250,000, could be adopted. It can always be changed by ministerial decree to take into account the changes in the tax administration capacity (Article 18).

Table 10. Egypt: Taxpayers of GST by Size of Turnover, 1995 (millions LE)

Size of Turnover	Taxpayers		Turnover	
In LE	*Number*	*% of Total*	*Amount*	*% of Total*
54,001 – 100,000	32,327	66	599	5
100,001 – 1,000,000	11,322	23	1,003	9
1,000,001 – 10,000,000	3,677	8	2,937	25
10,000,001 and more	1,339	3	7,067	61
Total	*48,665*	*100.0*	*11,606*	*100.0*

Source: Based on data provided by the General Sales Tax Department.

The suggestion to further rationalize the rate structure by limiting the positive rates to no more than two and maintaining exemptions and zero-rating at their current level should simplify the structure of the VAT and contribute to its administrative efficiency. Closely related to tax administration is taxation of small businesses, which usually represent the vast majority of taxpayers but with a small tax payment. This class of taxpayers does not usually keep reliable records, but faces higher compliance costs than other taxpayers (Table 11). The problem of small taxpayers is common under VAT and virtually all countries apply different schemes to this group, including complete exemption from the obligation to register.

Table 11. United Kingdom: Value-Added Tax:
Cost of Taxpayers' Compliance by Turnover Taxable Brackets (Thousands of LSTG)

Taxable Turnover Bracket	Compliance Costs as a Percentage of Taxable Turnover

0 - 49.9	1.17
50 - 99.9	0.54
10 - 999.9	0.24
1,000 and over	0.04

Source: C. Sandford, M. Godwin, P. Hardwick (eds.), *Costs and Benefits of VAT* (1981).

Complete exemption may offer administrative advantages, but in countries where a large share of the economy is in the hands of small businesses, exemptions may end in discrimination against medium- and large-scale enterprises. In the initial stage of VAT, a policy of taxing all businesses, regardless of size, could reduce the impact of cost-effectiveness and efficiency of the administration. *Small businesses may be exempt provided that the threshold is frequently revised to broaden the coverage of the tax.* The forfeit system, according to which estimated taxable sales remain in effect for two to three years, should not be used. This system is common in many countries influenced by French experience and concepts, but tends to remain in effect without revision for more than the conventional forfeit period and therefore can add to the rigidity of the system.

It should also be pointed out that small businesses, by being exempt, do not escape the VAT altogether. Their exempt status means that they are not entitled to claim any input credit and therefore, they are officially required to carry tax-paid stock. It is the value-added by their own activities that remain untaxed.

Taxation of Services

The proposed VAT, in an attempt to maximize neutrality and economic efficiency, should apply to all sales of services, as well as goods unless, explicitly exempt. Under the current GST, there are crucial differences between taxation of these two sales. Contrary to taxation of goods, the GST on services is cumulative as no credit is allowed for the tax paid at earlier stages. Another major difference relates to the coverage of the two sales. The sale of goods is taxed on a rather general basis, while services are taxed selectively. Taxable services are limited to those noted in Table 2.

The selective method in taxing services generates a negligible share of tax revenue from such an important sector of the national economy. In addition to the revenue loss, the selective method complicates determining services to be taxed and creates lengthy procedures to be followed in enacting legislation. These procedural problems must be dealt with each time a particular service is added to the list of taxable goods. Initially, there were eight taxable services, but over the last six years they have been expanded to 17 (Table 12).

In addition to the difficulty of determining taxable services, it should be emphasized that a good deal of exempt services are subject to stamp duties, some of which are at relatively high rates.

Replacing the GST with a VAT should facilitate the reform of services taxation by broadening the aggregate base, rationalizing the rate structure, reducing the combined burden by eliminating stamp duties, especially those with high rates, and extending the credit to tax paid at earlier stages.

From a positive list of taxation to a negative list of exemption. To reduce the problems associated with determining and enacting laws to tax new services, the proposed VAT may include the definition of services adopted by the EU's sixth VAT directive.

According to this directive, services are defined as each transaction which does not constitute a delivery or transfer of goods. This broad definition is becoming the norm in VAT legislation around the world, and it explicitly stipulates exempt services. Exemptions usually include some liberal professions, mainly medical and dental care, financial services including core and secondary services, insurance services, educational and cultural services and work by nonprofit organizations. These services are for illustrative purpose in view of the diversity among many countries in taxing particular services. *There is no uniform pattern of exempting or taxing services*.

The majority of services are currently taxed at the standard rate of 10 percent with a few exceptions. Services benefiting from the reduced rate of 5 percent happen to be closely related to tourism and are consumed by foreigners for which a reduced rate may be difficult to justify. *Thus, the standard rate should be levied on taxable services with no differentiation*. The concern about an increased burden on some services could be partially compensated for by allowing a credit for the tax paid in earlier stages.

Table 12. Egypt: Positive List of Taxable Services and Proposed Negative List of Exemptions

Code	Positive List [1]	Negative List [2]
1.	Hotels and tourist restaurants	Medical and dental care
2.	Tourist transportation services	Postal service
3.	Telex and facsimile services	Financial (core and secondary services) [3]
4.	Air-conditioned means of transportation	Insurance and reinsurance
5.	Sound & light show services	Noncommercial activities of nonprofit organizations
6.	Use of sound & light co.'s utilities	Cultural and educational services
٧.	Art agent's service in public and private parties	Radio, television, theater, cinema other than advertising
8.	Local telephone, telegraph services	Foreign exchange services

9.	International communication services	Lotteries
10.	Telephone installation and connection services	Renting immovable properties
11.	Employment contracts	
١٢.	Car rental services	
١٣.	Express mail (DHL) services	
14.	Maintenance and security guards	
15.	Public road services (tolls, etc.)	
١٦.	Brokers' services of real estate	
١٧.	Brokers' services for car sales	

1. Services from 8 to 11 were added by Presidential Decree No. 77/92; from 12 to 15 by Presidential Decree No. 295/93; and 16 and 17, by Presidential Decree No. 39/94.2. There is no standard worldwide list for exempt services, which vary from one country another. This list is for illustrative purposes.3. 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.

Equally important in taxing services is the registration threshold allowed to taxpayers providing services. It should be the same as for taxpayers subject to the tax on the sale of their goods, although some countries, such as Greece and Ireland, allow a lower registration threshold for taxpayers supplying services. The possibility that the threshold will be increased in connection with the shift to a VAT should not justify having a lower threshold for services. The generalization of the credit and the unification of the threshold would enhance the VAT neutrality and revenue yield as well as the integration of taxing services and goods. A higher threshold for services more than LE 54,000 may also be justified, because it would exclude the many services provided by small one-man enterprises that require minimal inputs.

Taxation of Excises under the Proposed VAT Under a VAT, excise duties are usually retained for only a narrow range of goods such as tobacco and cigarettes, petroleum products, soft drinks, alcoholic beverages and passenger cars. In Egypt, these goods generate the sizable share of revenue from excises (about 43 percent) and therefore, *excise duties must be limited in number to allow for future increases that may become necessary in case of reduction in high tariff rates*. Some goods may be made subject to excises to compensate for the revenue lost in import duties. This compensation should take place through excise duties instead of additional rates to the GST, as the Presidential Decree No. 65/95 increased the GST rate by 5 percent on the sale of different passenger cars.

While the principal share of revenue from excises is generated from domestically produced goods, the principle of equal taxation of imports should always be maintained. Excises on imports are usually added to the taxable base of the VAT along with customs duties. The fact that the principal share of revenue from excises is generated by the few duties on tobacco and cigarette, petroleum products and soft drinks, minimizes the justification for other duties noted in Table 1. Most of these

goods could be taxed easily under the GST. Taxing excisable goods under the GST would make them entitled to the tax credit.

Distributional Consequences of Shifting from GST to a VAT

This analysis has concentrated mainly on the gains in efficiency and revenue yield that may result from adopting a VAT. The impact of this reform on the distribution of the tax burden needs, however, to be considered in view of equity as the primary goal of the tax system.

According to the advocates of the traditional progressive taxation, the shift could be regarded as a regressive step because the tax system will be depending increasingly on consumption taxes. These taxes, sometimes classified as indirect taxes 'in realm,' do not differentiate according to ability to pay and therefore tend to discriminate against low-income groups. On the other hand, income taxes maximize the norm of ability to pay because they have 'income' as their base, deduct necessary charges, take into consideration the family situation through personal exemptions, and finally apply progressive rates.

The regressivity of the proposed value-added tax tends to be overstated if 'income' is not accepted as the best indicator of ability to pay. Today, there are growing views that regard the traditional concept of income as fairly old fashioned and even puritanical.[١٧] Consumption is frequently considered the appropriate tax base, because it is the best measure of taxpayers' enjoyment and satisfaction from consumed goods and services. This view may be substantiated by the recent development of the Egyptian tax system. The analysis has already revealed that individual income taxes are declining in relative terms and their buoyancy despite the progressive rates is lower than unity (Tables1-4). These developments should illustrate the limited role of these taxes in improving the overall incidence of the Egyptian tax system. Meanwhile the value-added, if adopted, will be fairly proportional to the expenditures of different categories of taxpayers, irrespective of the level of their income.

In the view of the declining buoyancy of individual income taxes and the growing acceptance of expenditure/consumption as an appropriate base, the suggested value-added tax would not have adverse distributional effects. This conclusion can be further substantiated by:

1. The current GST and the proposed VAT will not burden low-income families as much as is sometimes claimed. The exemption and the application of a reduced rate on essential and necessary goods and services that are usually consumed by this group of taxpayers mitigate significantly the burden.

[١٧] For more details see, Joseph A. Pechman, "*What Should be Taxed: Income or Expenditure?*" 1980, p.303.

2. The incidence of some categories of taxes or even the entire tax system is no more meaningful as an indicator of the distributional impact of the public sector. This impact should also take into account the benefits received by low-income families and financed, partially, by broad-based taxes. These benefit the low-income families more than the distribution of the tax burden, which tends to fall on those in high-income brackets.[١٨]

3. The distributional impact that would follow the proposed VAT will tend to be quite limited in view of the fact that the large share of goods and services are already taxed under the current GST. On the contrary, the generalization of the service taxation should be seen as the closing of loopholes and improving in the overall distribution because services to be taxed are usually consumed by those in high-income brackets.

IV. Conclusions and Recommendations

To restate, a number of comprehensive tax reforms were introduced during the decade 1986-1996, in support of 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 and lower rates; (2) the 1991 reform of taxes on goods and services, which introduced the principle of general taxation of goods and services in lieu of the scattered excise duties and partial consumption taxes; and (3) the 1993 reform of taxes on income and profits, which replaced the scheduler and complementary income taxes with a global income tax and removed the combined high tax rates 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 the results since their introduction. The improvement in taxes on income and profits, as measured by the large share of revenue, should not disguise that the principal share of revenue is contributed by the three major public enterprises (oil, the Suez Canal, and the Central Bank), suggesting that this category depends primarily on sources that are

[١٨] For more details of these views,see, Richard A. Musgrave, *Progressive Taxation, Equity, and Tax Design in Tax Progressivity and Income Inequality*, edited by Joel Slemrod, 1994, pp.341-355.

neither stable nor permanent. And the general income tax, despite its progressive rate and the recent improvement in the economy, generated the lowest share of tax revenue (0.7% of GDP) compared with many countries included in this study and registered a buoyancy lower than unity.

The 1991 GST is increasingly becoming an important pillar of the tax system, especially as the forthcoming free trade association with the European Union, since the association will require elimination of customs duties and other taxes affecting imports of EU origin. The actual experience of the last six years shows improvement in revenue productivity, reduction in distortion and cascade effects, and reinforcement of the administration of taxes on goods and services. However, the GST bears the following defects:

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

٢) Although the rate structure of the GST was partially rationalized following consolidation of the two increased rates into one, it needs further rationalizing and limiting of the positive rates to no more than two.

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

٤) Lack of generalizing the 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 to 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 wholesalers and retailers. The expected improvement in efficiency and revenue from adopting a VAT will not necessarily result in unfavorable distributional impact. On the contrary, the generalization of service taxation should be seen as a removal of loopholes and an improvement in the tax distribution since services are usually consumed by those in high income brackets. In order to convert successfully the GST to a VAT, the following approach is necessary:

Broaden the base of VAT:

- In taxing the distribution sector, *the proposed VAT should eliminate the distinction between of wholesalers and retailers*. The experiences of many other countries suggest that these concepts will not lend themselves to effective application, and the vast majority of countries apply VAT at multiple stages, including retail, through a threshold.

- *A threshold registration is central to VAT*. It should be high enough to exclude the many small taxpayers whose taxes would not cover the costs of their registration, control of declarations, refunding credits, etc.
- *The new threshold should be the same for all taxpayers*, including those who provide services or produce goods noted in Table .

Generalize the tax credit:

- *The input credit should be generalized and cover the entire amount of the GST/VAT paid in the earlier process of production and distribution*. The current practice discriminates against capital-intensive industries and creates problems by treating credit on the purchase of capital goods as depreciation over a period of 5 to 10 years. Many countries, after lengthy debate, credit the full VAT on capital equipment.

Rationalize the rate and improve tax administration efficiency:

- *The increased rate of 25 percent and the standard rate of 10 percent should be consolidated into a new rate of 12-15 percent*. This would simplify administration, rationalize the rate structure and possibly increase revenue to compensate for revenue lost following other suggested reforms.
- Eliminating the increased rate should not raise concern about reducing rate differentiation and the possibility of adding regressivity to taxation of goods and services. Recent experiences of many countries confirm that rate differentiation, and in particular higher rates, have very little impact, if any, on the distributional effects. In 1992, all OECD countries, with the exception of Turkey, eliminated higher rates and limited the number of VAT rates to no more than two. Four out of six member countries of ASEAN apply a single tax rate.

Tax services:

- *The selective methods of taxing services should be generalized*. The positive list of taxed services (Table 2) should be replaced by a negative list of services to be exempt with all other services being taxed.
- *The cumulative incidence of the GST on services should be removed*, and all tax activities liable to the GST/VAT should benefit from the credit.

Tax excises under the VAT:

- Some excise duties shown in Table 1 continue to apply rates that date back to 1981 when the consumption tax came into effect. *Excise duties should be curtailed in number* and confined to goods for which a strong case can be made for a significantly higher rate than those of the GST/VAT (i.e., tobacco and cigarettes, petroleum products, soft drinks, alcoholic beverages and passenger cars). Other excisable goods should be taxed under the reduced or normal GST/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 generated from each commodity and a price level to be charged to the final consumer.
- Excise duties, despite the suggestion to curtail their number, are expected to have an important role in view of future reductions in the 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 & Law No.2/97).
- Stamp duties, especially on services that will be taxed following the generalization of service taxation, should be reduced to lower the combined burden of VAT and stamp duties on these services.

The essential recommendation of this study is to convert the GST into a VAT, broaden the aggregate base, rationalize the rate structure, generalize the tax credit, and integrate taxation of services with taxation of goods. The reform should be comprehensive and structural, not ad hoc like the changes introduced over the previous six years. Converting to a VAT is a logical evolution and corresponds to the global trend of value-added taxation as the most productive revenue generator with the least economic distortions.

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