

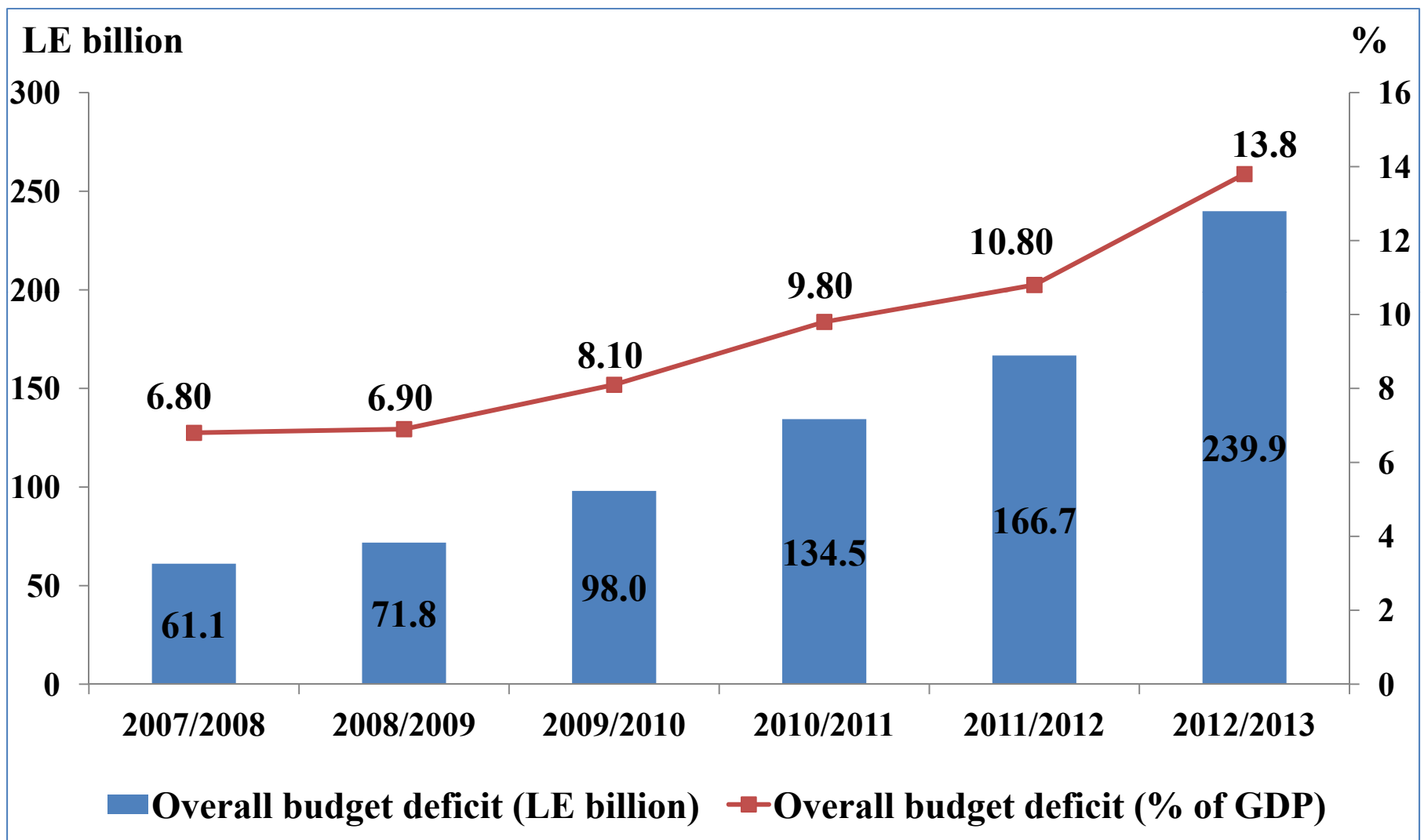


THE MERITS OF A VALUE-ADDED TAX IN EGYPT

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18 November, 2013

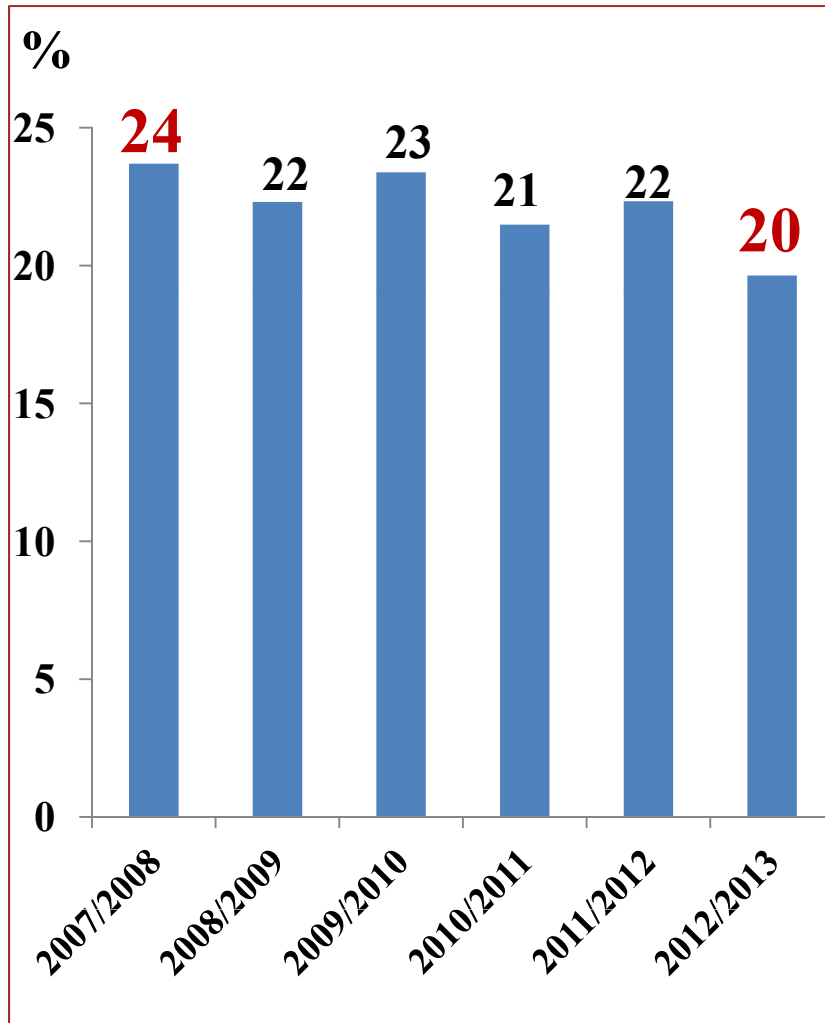
Securing revenue is much-needed to: contain the high and increasing budget deficit in Egypt



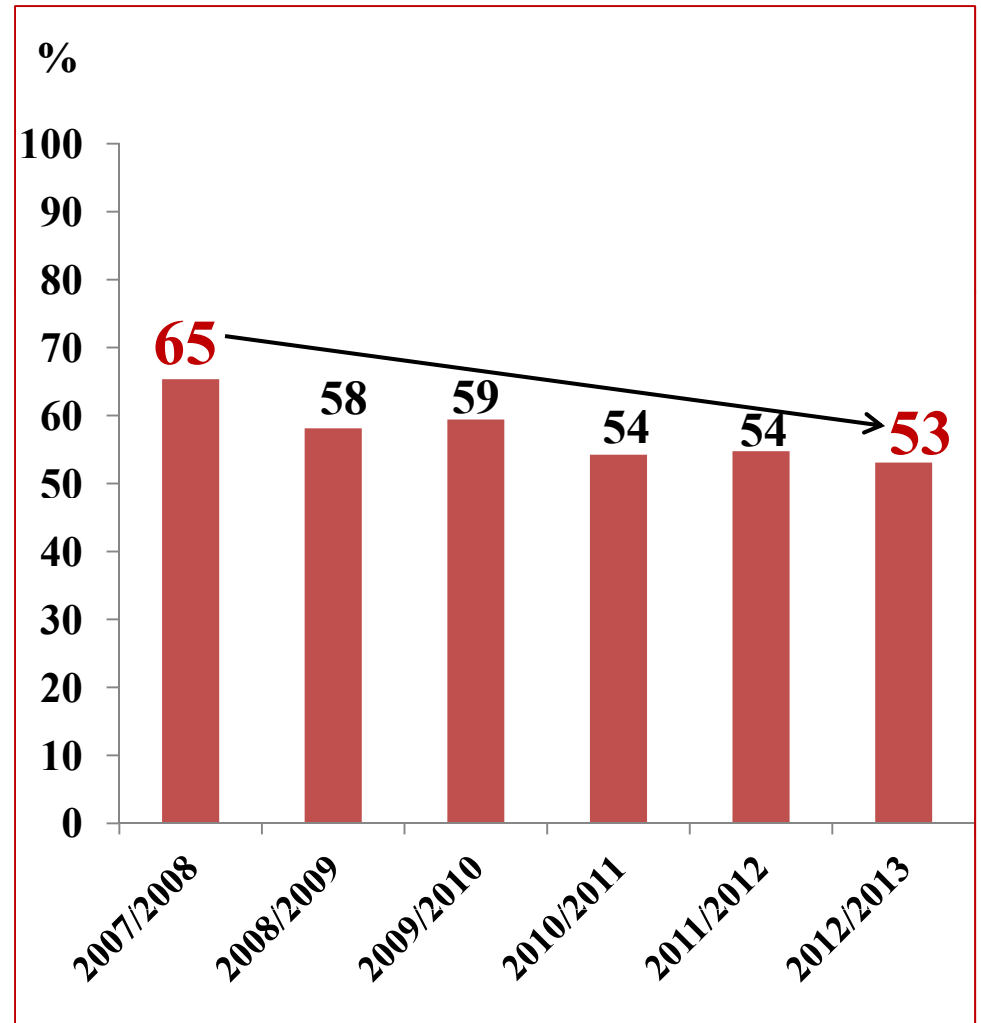
Source: Ministry of Finance.

Securing revenue is much-needed as: the General Sales Tax (GST) has been declining over the past six years

GST (% of total tax revenues)



GST (% of taxes on goods and services)



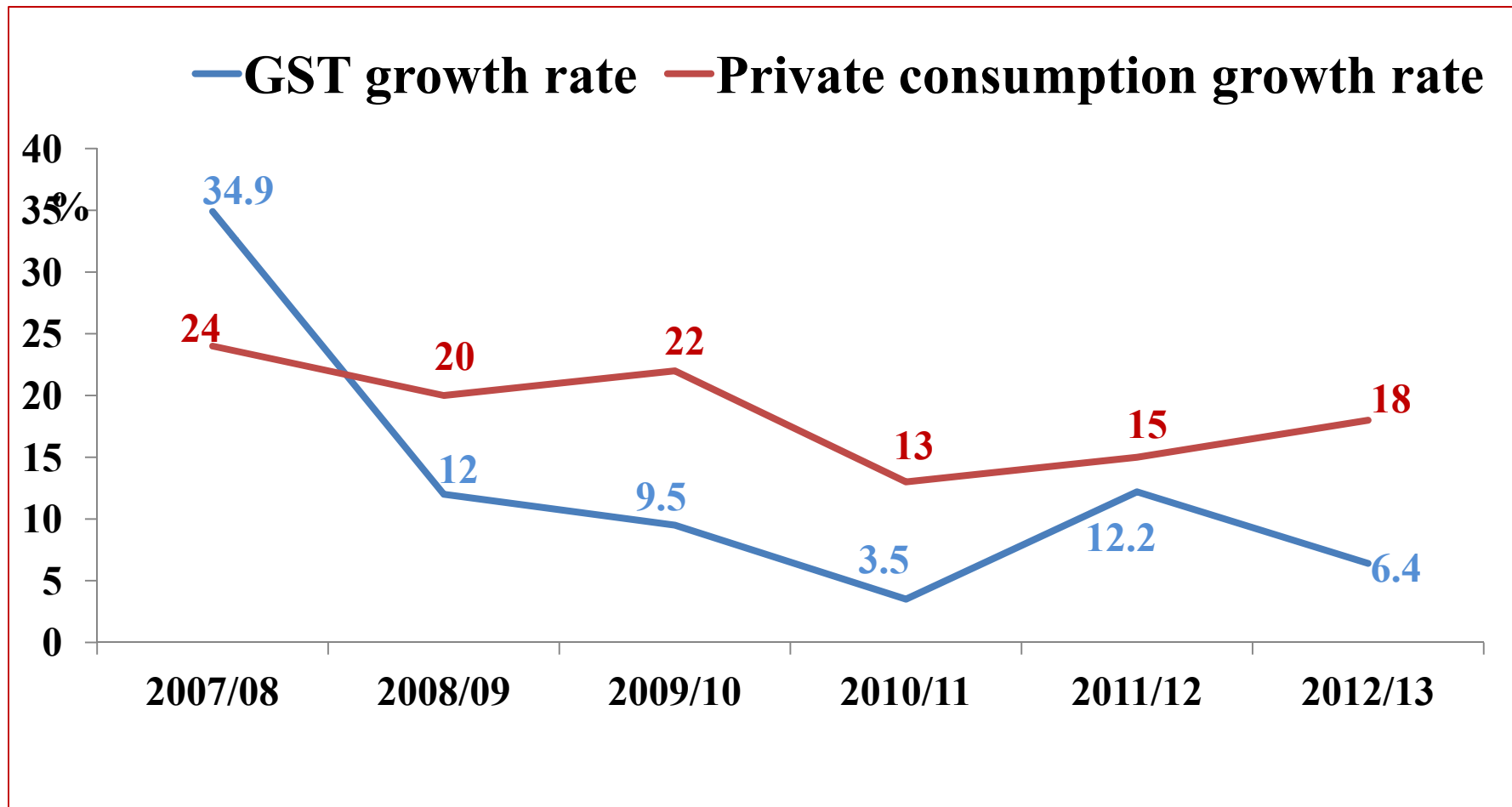
Source: Ministry of Finance.

Securing revenue is much-needed by: broadening the tax base to include more services



Source: Ministry of Finance.

It is possible to increase the tax revenue on goods and services, as private consumption is growing at a higher annual rate (19%) than the sales tax revenue (13%)



Source: Ministry of Finance.

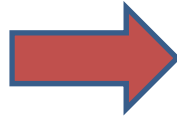
Main Issues

- 1- Why the VAT in Egypt and how it works?
- 2- Who are the potential winners and losers?
- 3- What are the prerequisites for its efficient and equitable implementation in Egypt?

1- Why the VAT in Egypt and how it works?

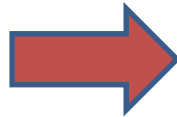
Why a VAT and how it works ?

➤ The VAT is a broad-based tax on consumption (should include all goods and services), ultimately paid by final consumers



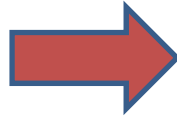
- secures high and stable revenue
- avoids cascading*
- maintains production efficiency by minimizing the interference in the allocation process (Neutrality)

➤ The VAT is levied on imports



- secures revenue

➤ The VAT is levied at each stage of production and cumulates

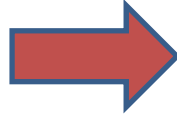


- the invoices for each transaction provide a better audit trail than the single retail sale
- avoids tax evasion

***Cascading** occurs when a good is taxed more than once as it makes its way from production to final retail

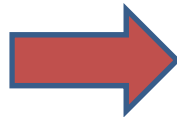
Why a VAT and how it works ?

➤ The VAT does not tax business inputs



- avoids cascading
- the tax is not passed to consumers in the form of higher retail prices
- maintains production efficiency by discouraging businesses to “vertically integrate” to avoid paying taxes on inputs to the production process

➤ The VAT could be rebated entirely on exports by using a zero-rate on export sales while refunding any tax paid on inputs



- promotes exports
- VAT refunds are part and parcel of the VAT system because they result from offsetting input VAT against output VAT, combined with the application of a zero rate on exports

The VAT works across the supply chain

In LE	Plastic Factory	Toy Factory	Retail Outlet		Gross VAT Collected	Gross VAT Credited	Net Government Revenue
Purchase price	0	110	330				
Sales price	100	300	350				
VAT (assumed at 10%)	10	30	35	→	75		
VAT credit (for the tax paid on the input)	0	10	30	→		40	
VAT payment to the government	10	20	5	→			35

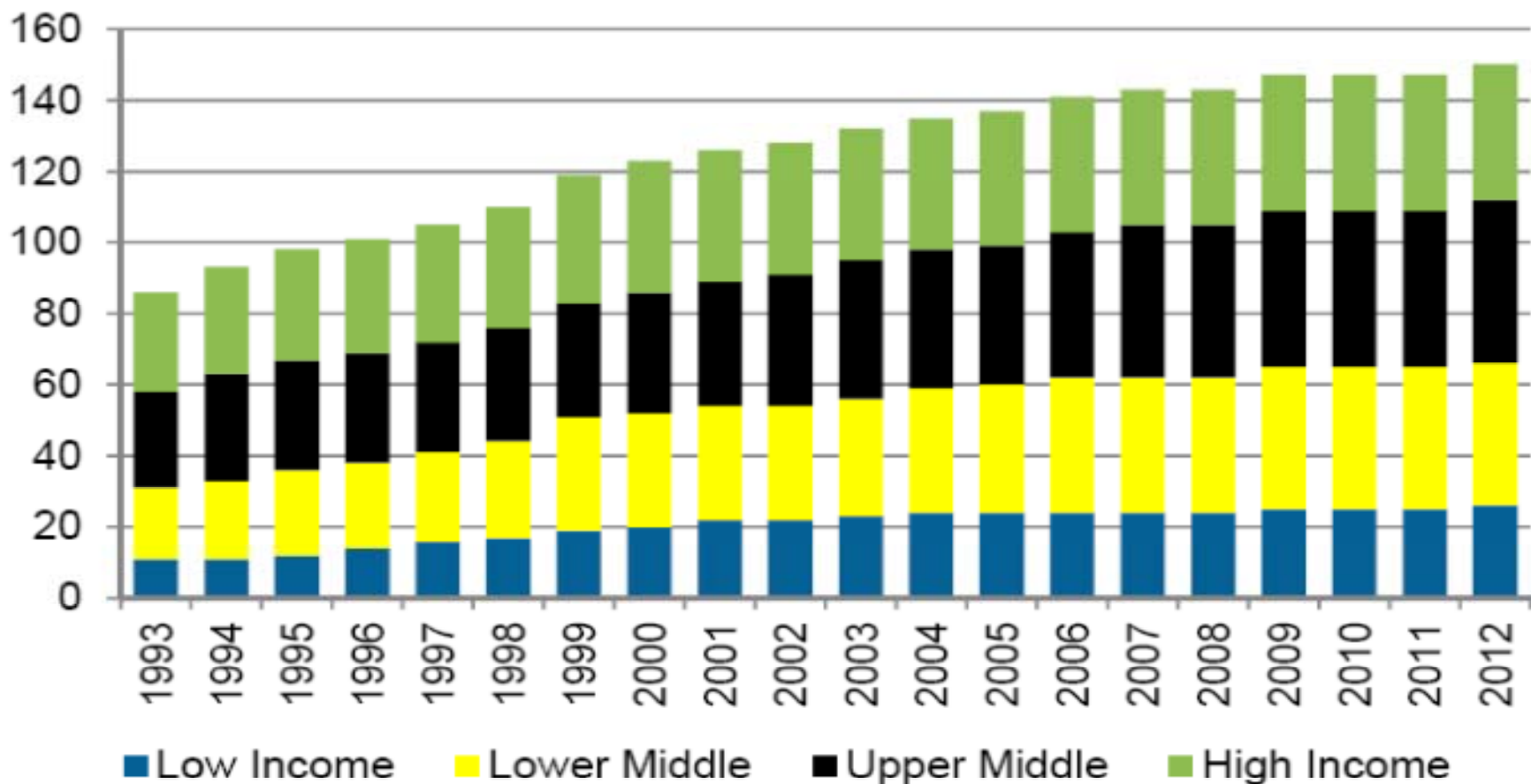
VAT payable = VAT on sales - VAT on goods and services purchased
 (Every business in the supply chain remits the difference between the VAT paid to suppliers and the VAT charged to customers)

2- Who are the potential winners and losers?

A well-designed and applied VAT could raise substantial revenue for the government, but:

- A substantial **informal sector** complicates the taxation of consumption
- Taxing consumption is usually assumed to be more **regressive** than taxing income
- **Inflationary pressures** are expected to increase
- The **administrative capacity** of **the revenue authority**, as well as, that of **the private sector** through accounting and reporting (compliance costs), should be strengthened
- **Resistance** to the introduction of VAT could arise (for example, the resistance to using of information acquired from the VAT to strengthening the income tax)

Fifty years ago the VAT was rarely heard of outside France, now it is found in over 150 countries, where it raises 20% of all tax revenue



Source: IMF, 2013

A well-designed and applied VAT could raise substantial revenue for the government

A sample of 83 countries	Low income countries	Lower-middle income countries	Upper-middle income countries	High income countries
Number of countries adopting the VAT	11	26	22	24
Standard rate (% , average)	15.8	15.3	17.7	17.8
VAT revenues as a % of total tax revenue	26.2	31.1	29.2	23
C-efficiency*	0.29	0.45	0.49	0.69

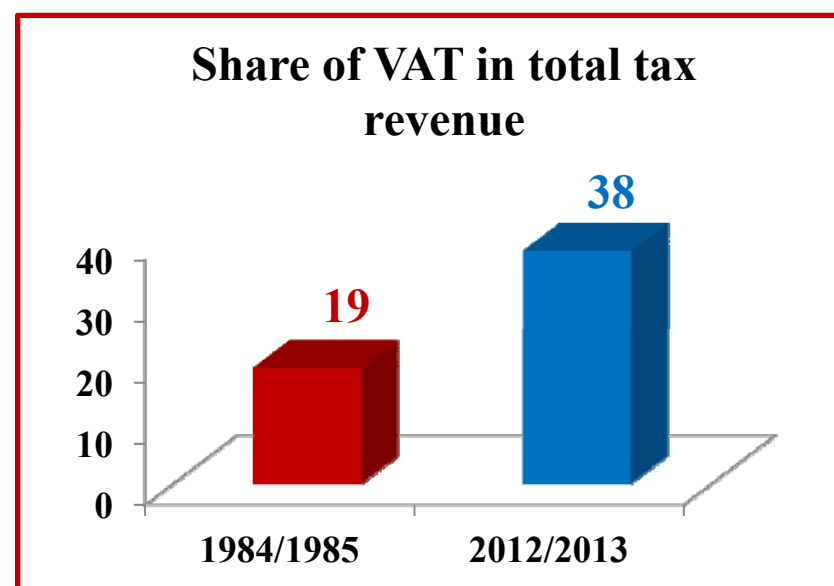
• **C-efficiency is the ratio of actual tax revenue to potential tax revenue. An ideal VAT would have a ratio of 1. While a ratio below 1 would mean lower efficiency, a ratio of more than 1 usually signals a cascading effect (e.g., Israel and Singapore have a ratio of 1.07 and 1.35, respectively).**

In 1985, Indonesia introduced the VAT. In 2012/13, the VAT became a key source of revenue

➤ Indonesia's VAT in a nutshell

	Year of implementation (1985)
Standard rate	Standard of 10% with 5 and 15 % rates for some items
Tax to replace	General sales tax on good and services
Threshold (annual)	IDR 600 million (approximately USD 65,000)
Exemptions	Several items for social and administrative reasons of which the most important are <ul style="list-style-type: none">• basic commodities• medical and educational services• financial and insurance activities

➤ In 2012/13, the VAT accounts for 38% of total tax revenue and 3% of GDP, with a C-efficiency ratio of 0.6



There are many similarities between Indonesia in 1984, a year prior to the implementation of the VAT, and Egypt in 2012/2013, considering the introduction of the VAT

<u>Comparison item</u>	Indonesia in 1984*	Egypt In 2012/2013**
Income group	Lower middle income	
Real GDP growth rate	6	2.1
Informal sector (% of economic activity)	35	40
Private consumption (% of GDP)	65%	81.2%
Tax revenue (% of GDP)	16%	14%
General Sales tax revenue (% of total tax revenue)	19%	20%
Imports (% of GDP)	22	25
Agricultural sector (% of GDP)	23	14

Sources: * http://www.ic.keio.ac.jp/en/download/jjwbgsp/1998/1998_1Indonesia.pdf and <http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Documents/indonesia-oct30-2012-vat.pdf>

**** Ministry of Planning, Ministry of Finance and World Bank Development Indicators**

Theoretical VAT revenue estimate for Egypt

- Calculation is based on Egypt's input/output table (latest available 2008/09)
- The following categories from the input-output tables have been used:
 - 1- Final household consumption
 - 2- Gross fixed capital formation of the exempt sectors
 - 3- Intermediate consumption of the exempt sectors

VAT theoretical revenue (in millions of LE) , assuming a VAT rate of 10%			GST actual revenue (LE millions) in:	
			2008/09	2012/13
VAT theoretical revenue			113,781	49,298**
	LE millions	% of total VAT revenue		
-Final household consumption*	83,581	73%		
-Gross fixed capital formation of the exempt sectors	10,784	10%		
-Intermediate consumption of the exempt sectors	19,416	17%		

* Excluding the final household consumption of exempt sectors (9 sectors out of 20 sectors)

** Source: Ministry of Finance, Monthly Statistical Bulletin, September 2012/13.

VAT, as a consumption tax, is regressive

- When moving up the income scale, the ratio of consumption to income falls, as does the ratio of tax burden to income
- Low-income groups spend a *relatively* larger part of their income on consumption than higher-income groups
- Consequently, low-income groups pay more consumption tax (VAT) *relative* to their income. In *absolute* terms, they may pay less

Families (of same size but different income levels)	Annual disposable income (LE)	Saving , LE	Consumption, LE	Paid taxes at VAT rate= 6%	Tax burden (tax as a % of disposable income)
Low-income	22,000	0	22,000	1,320	6.00%
Middle- income	40,000	5,000	35,000	2,100	5.25%
High- income	110,000	30,000	80,000	4,800	4.36%

The price effects of adopting a VAT are important in Egypt, where inflation and inflationary expectations are present

- Adopting a VAT would probably lead to a one-time increase in consumer prices in direct relation to the coverage and rate of tax *
- A broad, but realistic, tax base would cover about 80 percent of total consumption expenditures.
- If a 10 percent VAT were applied to this base, consumer prices would rise by nearly 8 percent
- This would be a one-time increase in the consumer price level, not an annual occurrence
- There may be some secondary price increases because of wage payments and other business contracts that are indexed to the general price level, but these would be modest by comparison with the initial increase

*** However, the VAT will replace the current General Sales Tax, mitigating the one-time increase in prices**

٣- ما هي الشروط اللازمة لتطبيق هذه الضريبة بصورة
فعالة وعادلة؟

VAT credits could be an incentive to formalize

- The implementation strategy should aim to ensure that the VAT does not push more firms into the informal sector, but rather act as an incentive to formalize
- **Incentive to formalize across the value chain**

Value chain:	Initial input creators (raw materials)	The rest of the supply chain (processing, packaging, manufacturing)	Exporters (finished goods)
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Incentive to formalize:	VAT credit is not a compelling reason to comply/formalize (this is beginning of supply chain)	VAT credit is a reason to formalize, but only if the firm has “access” to formal inputs (collect input VAT)	VAT credit is a significant reason to formalize (have substantial VAT credit to collect)
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VAT credits could be an incentive to formalize

- A quick and easy registration process will help encourage businesses to participate in the formal tax system
- The VAT collection and payment system must be simple enough that there is an incentive (or rather a lack of disincentive) for the initial input creators to register and comply
- Because informal companies outside the VAT system are unable to claim VAT credits on their inputs, they have an incentive to formalize in order to reap this benefit
- If the company providing the inputs is not complying with the VAT, then there is much less incentive for the purchaser to comply
- At the other end of the value chain, major exporters can be used in building formal supply chains that will encourage their suppliers to also formalize

To balance the regressive effect of the VAT system, four remedies are usually applied:

- Avail exemptions, reduced rates and zero rating to goods and services primarily procured by low-income families
- Have a fairly high threshold (exempting smaller enterprises, whose sales often loom particularly large in the budgets of the relatively poor, thus increasing the VAT progressivity)
- Reform the income tax simultaneously
- Impose high excise sales tax on selected goods that have with negative externalities and low demand elasticity, such as alcohol, tobacco and motor vehicles

However, exemptions, reduced rates and zero rating are “not” recommended since they:

- cost substantial revenue,
- add to the administrative complexity of the system,
- deviate from the principle of uniformity of treatment of all consumption expenditures,
- facilitate evasion and corruption and
- are hard to remove once they are established



- keep them few and simple
- keep records over who receives what concessions and over what cost they involve in revenue forgone
- evaluate each tax concession on a regular basis to examine whether the concession achieves the results it was aimed for

To minimize resistance to the introduction of the VAT

- The VAT should be timed to avoid inflationary pressures. Introducing the VAT at a time when the currency is depreciating and imported goods are more expensive, would receive much of the blame for the higher prices, fueling public opposition
- The standard VAT rate *at the time* of introducing the VAT should not exceed the current General Sales Tax rate, for taxpayers to adapt to the new tax system
- Accompany the introduction of the VAT with a commitment that information acquired from the VAT would not be cross-checked against *past* income tax declarations

Minimize compliance costs for businesses through:

- Recruiting and training staff in tax administration techniques in general and on the VAT mechanisms in particular
- Preparing and enacting legislation
- Developing computer systems to administer the tax
- Making VAT information widely available and providing effective taxpayer education
- Introducing electronic filing of VAT returns to reduce the time needed to register and file returns

*** Tax compliance costs are defined as all tax-related costs incurred by the private sector other than the taxes paid to the government**

Also, to minimize compliance costs:

- Raise the VAT threshold to exclude small taxpayers
- Reduce the number of VAT rates to simplify the system
- Have minimal exemptions
- Apply a zero rate *exclusively* to exporters.
- Process VAT refund claims quickly because delays in reimbursement of VAT to exporters amounts to a tax on exports (The refund processing time in most countries takes an average of 30 days and reliable exporters get their refunds without extensive checks and audits)

Strengthen the capacity of the tax authority to monitor

- Rely on voluntary compliance and self-assessment (meaning that taxpayers declare and pay tax due, subject to audit and penalty)
- Ensure that all VAT taxpayers have easy access to complete and correct information about what is expected of them
- Adopt risk-based assessments of audits, which minimize the pool of companies that needs to be audited and allow the revenue authority to target high-risk companies

Conclusion

- The VAT is effective in raising revenues much-needed to finance Egypt's high budget deficit, provided that the capacity exists to administer the VAT adequately
- The design and implementation of the VAT system should be based on the structural characteristics of the economy (e.g., informality) The **NOSFA** principle
- Achieving social equity requires designing a more progressive VAT system, coupled with income tax reform