Towards Mobilizing Additional Fiscal Revenues and Boosting Economic Activity

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Introduction

At first, The presentation aims at assessing the Egyptian experience with tax reforms in 2005.

Secondly, It explores the effect of the tax reform on tax revenues and economic activities .

Finally, It presents policy options for tax reform in Egypt by introducing international experiences that could be relevant for Egypt towards boosting government revenues and mobilizing economic activity.

Widening Fiscal Deficit

- Fiscal deficit widened in 2004/05, registering 9.6 as percentage of GDP. This can be attributed to an increase in expenditures, coupled with shrinking revenues.
- The ratio of public revenues to public expenditures amounted 67 % in 2004/2005.

Weak Business Environment

- Investment in 2004/05 was 17.8 percent of GDP.

Reform 2005

- Widening the fiscal deficit with low investment ratio pushed the government towards tax reform in 2005 to mobilize additional revenues and promote economic activity.

The objectives of the tax reform in 2004/2005

Tax Revenues

- widening the tax base to embrace larger number of participants in the system, increase tax revenues and reduce budget deficit.

Business Environment

- Improve the business climate and Egypt's competitiveness to promote economic growth.

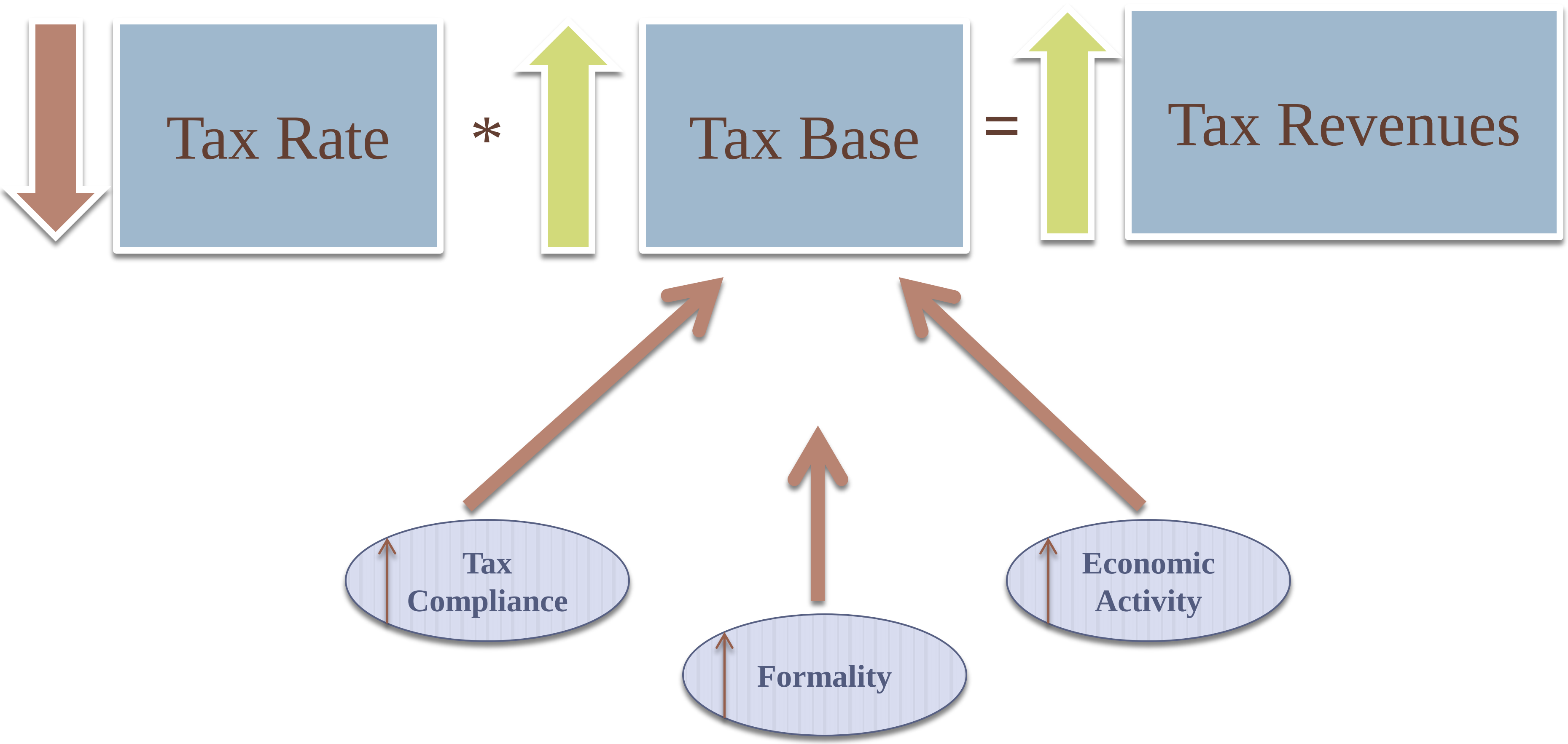
Efficiency

- Facilitate the tax collection method which led to reduce the cost, incurred by tax payers and tax administration.

Formality

- Streaming the tax system would help reduce informality towards mobilizing additional revenues.

Successful tax reform requires: reducing the tax rate to stimulate more activity and reduce tax evasion, widening the tax base in order to achieve higher revenues for the government.



Tax reforms in 2005 targeted both personal and corporate income tax rates.

Income Tax

Pre reform 2005

Wages and salaries	Tax rate	Commercial and industrial profits	Tax rate
below LE 50,000	20 %	below 2,500	20 %
		2,500-7,000	27%
over 50,000	32%	7,000-16,000	35%
		over 16,000	40%
		+ 2% income development fee on more than 18,000	

Post reform 2005

Income tax	Tax rate
below LE 5,000	0%
LE 5,001 – LE 20,000	10%
LE 20,001 – LE 40,000	15%
over LE 40,000	20%*

Corporate Tax

Pre reform 2005

Manufacturing	Other
34%	42%

Post reform 2005

Corporate tax rate has **been cut to a 20% flat rate***

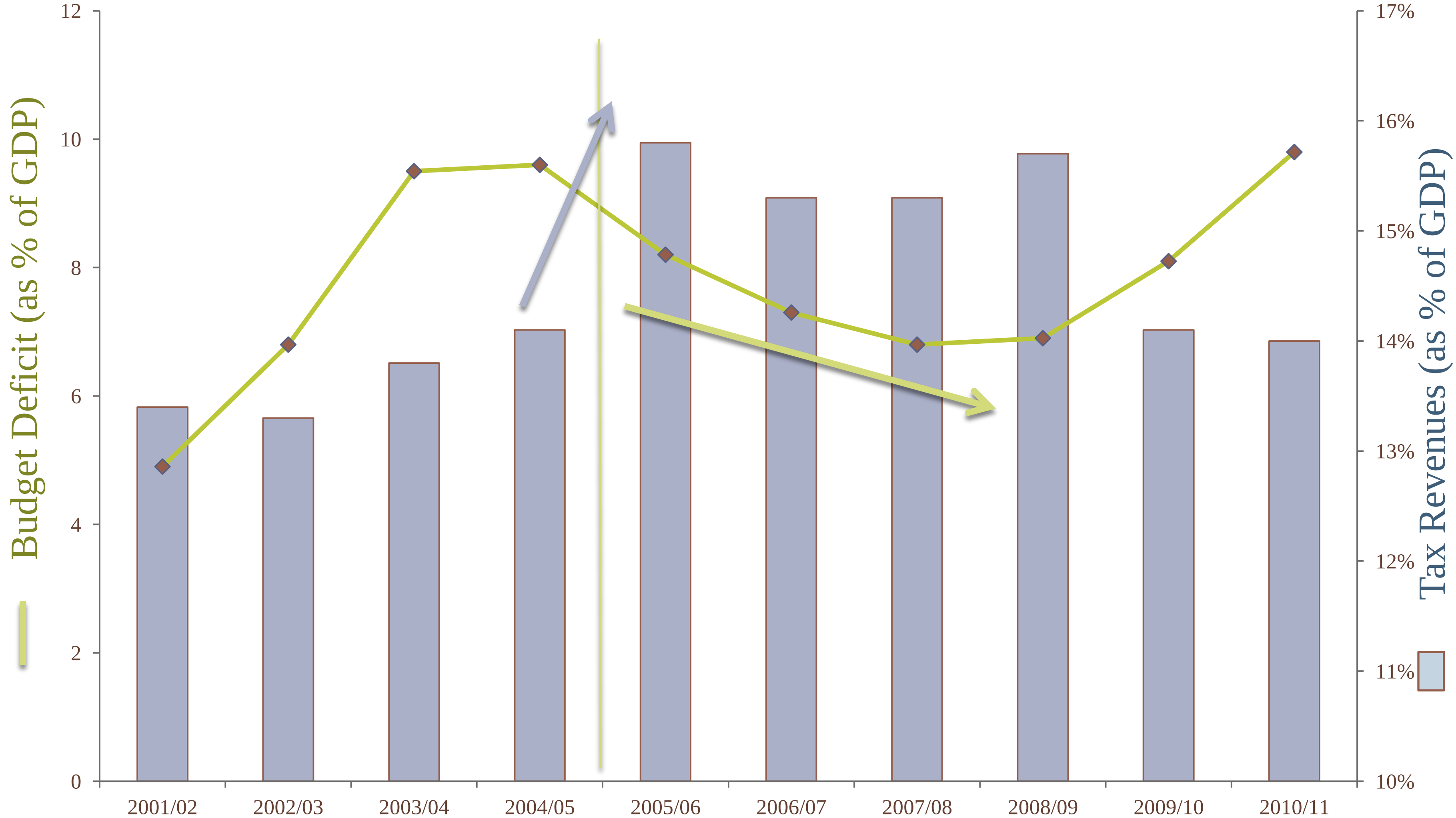
* In 2011/12, a new bracket of individuals and corporate base **above 10 millions** was introduced with a **25% tax rate**.

The 2005 Egyptian tax reform effect on:

- **Tax Revenues**
- **Macro Economic Indicators**
- **Efficiency of Tax Administration**
- **Informal Sector**

Tax Revenues post reform.

The tax reform was an important pillar of fiscal consolidation. Tax revenues as a percentage of GDP increased post the reform, reducing the budget deficit as percentage of GDP.

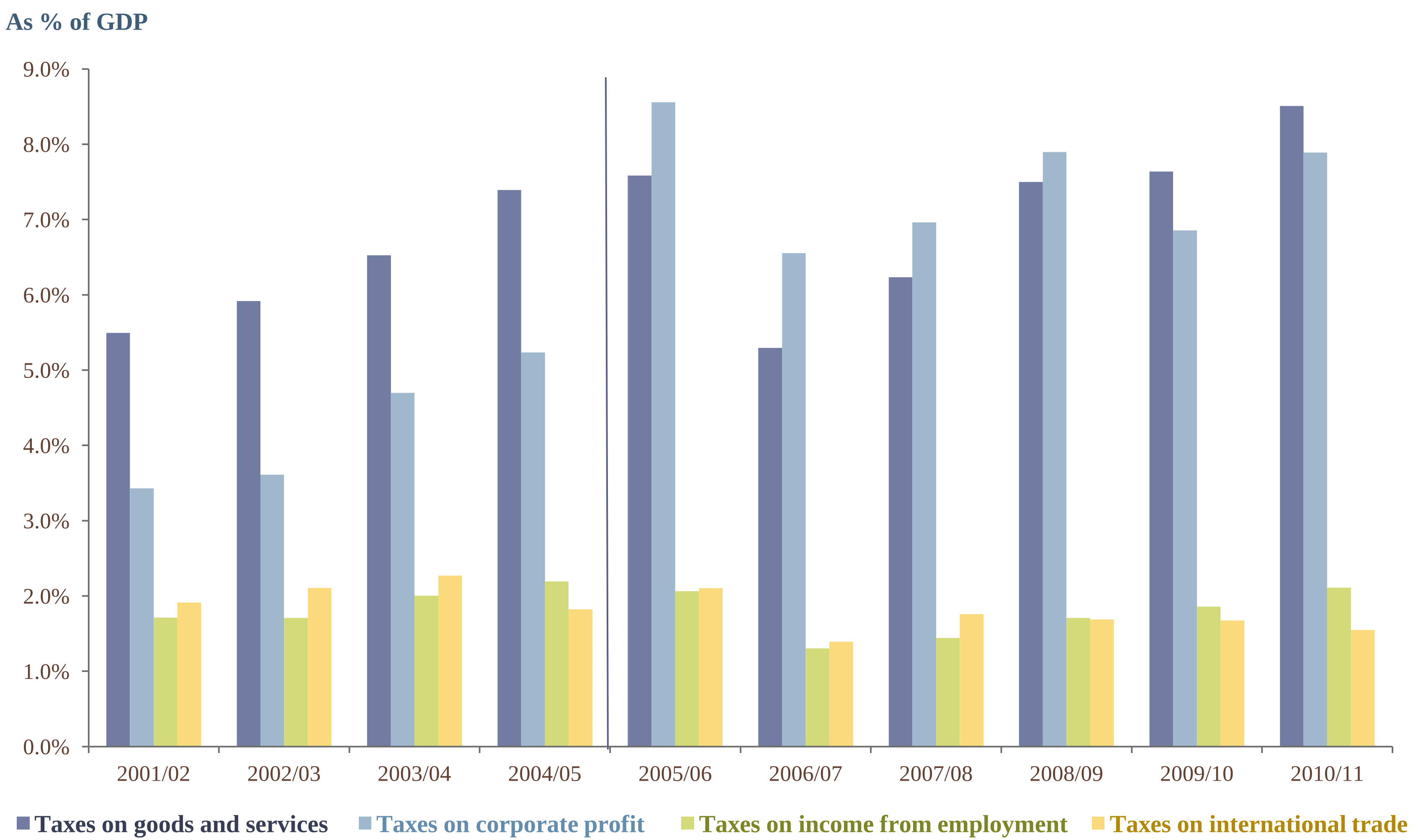


Source: ministry of finance, the financial monthly Bulletin.

The ratio of public expenditures to tax revenues post the reform declined despite higher expenditures ratio to GDP in 2005/2006.

Source: ministry of finance, the financial monthly Bulletin.

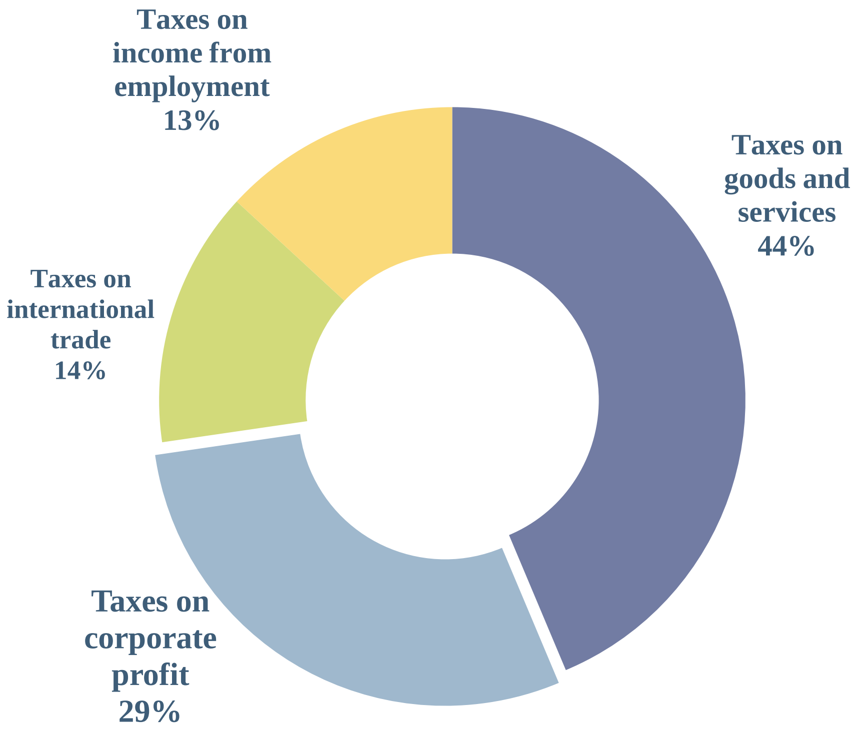
Post tax reform with stimulating economic activity, the share of corporate tax in GDP became the highest in line with the tax reform objectives.



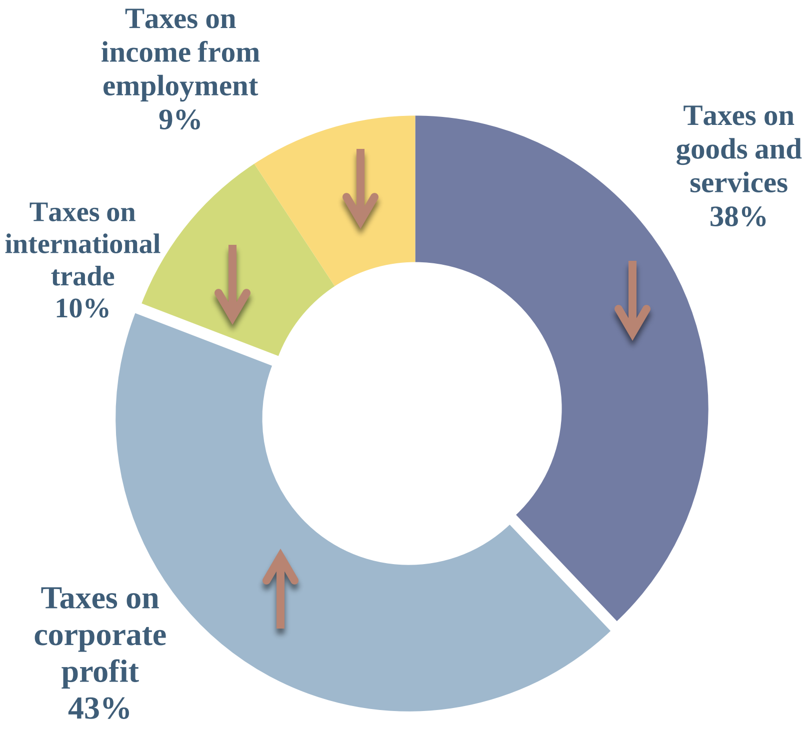
Source: ministry of finance, the financial monthly Bulletin.

Corporate tax revenues have increased, in spite of the reduction in the tax rate, reflecting significant increase in the tax base. This was the major contributor to improvement in tax revenues post reform, notwithstanding the decline of other taxes.

Average 4 year Pre Reform



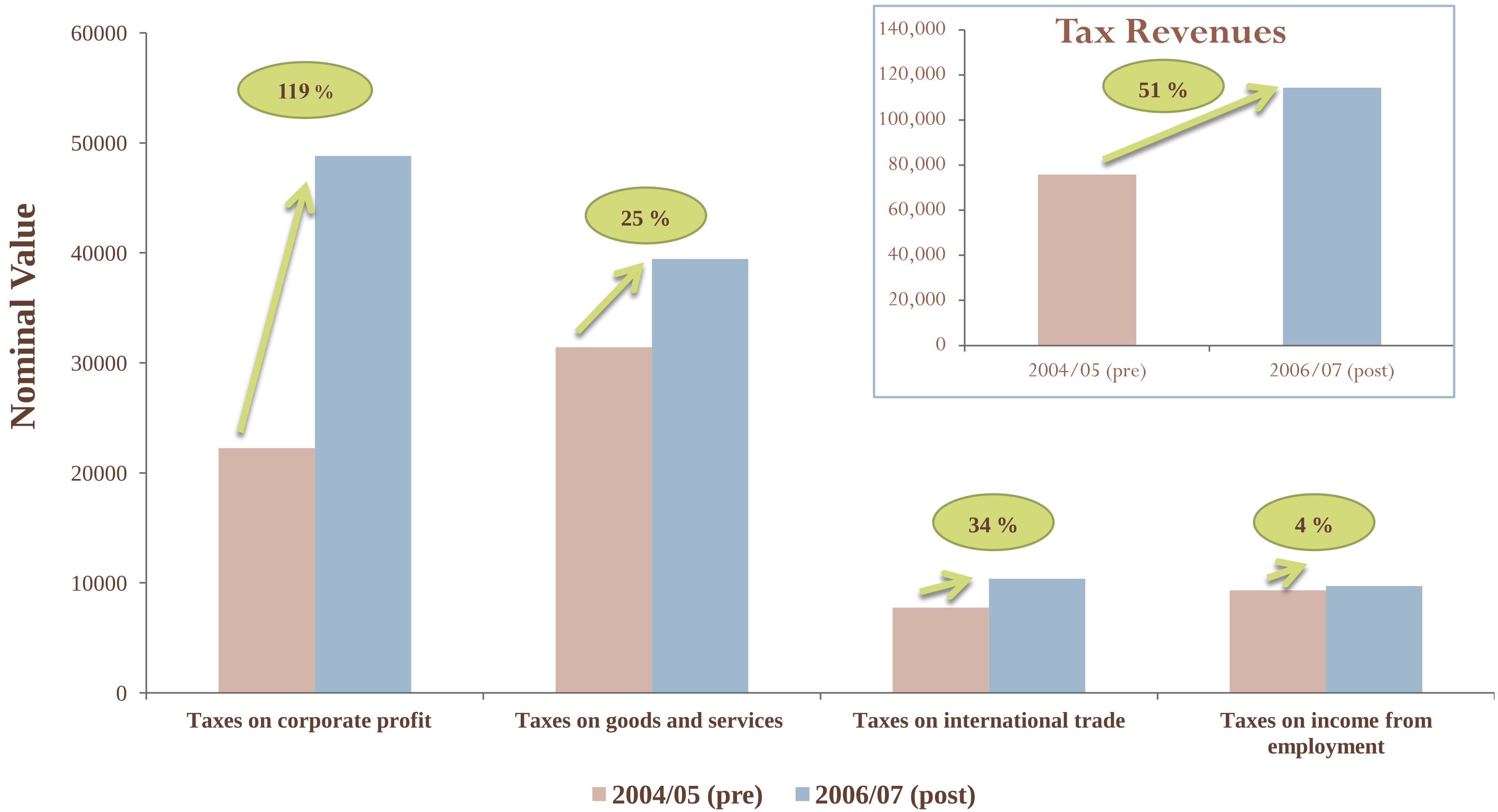
Average 4 year Post Reform



As % of Tax revenues

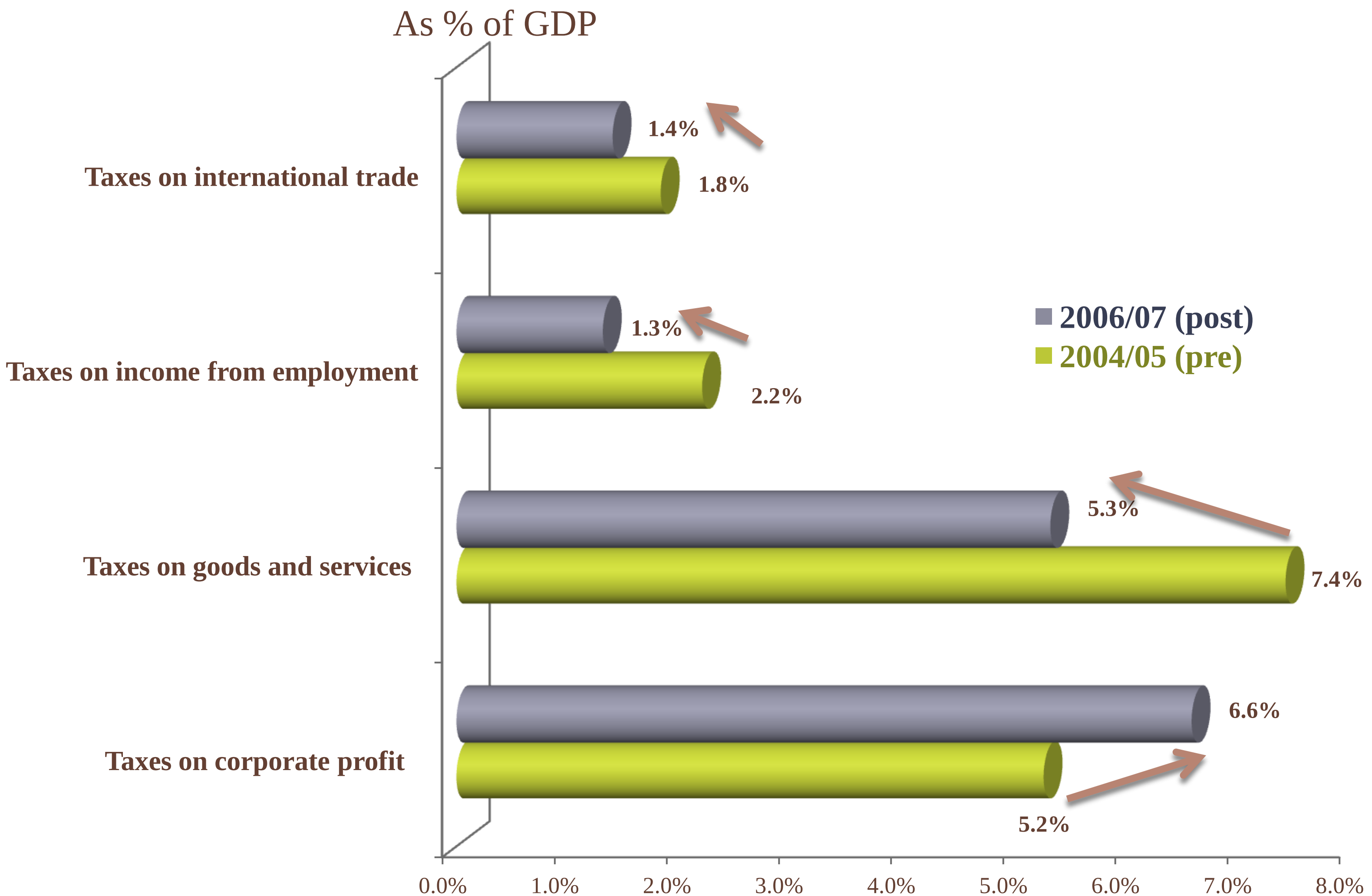
Source: ministry of finance, the financial monthly Bulletin.

Indeed , corporate taxes, in nominal value, grew by 119 percent in the year post the reform. The increase continued over the following years, while Other taxes growth rate was lower.



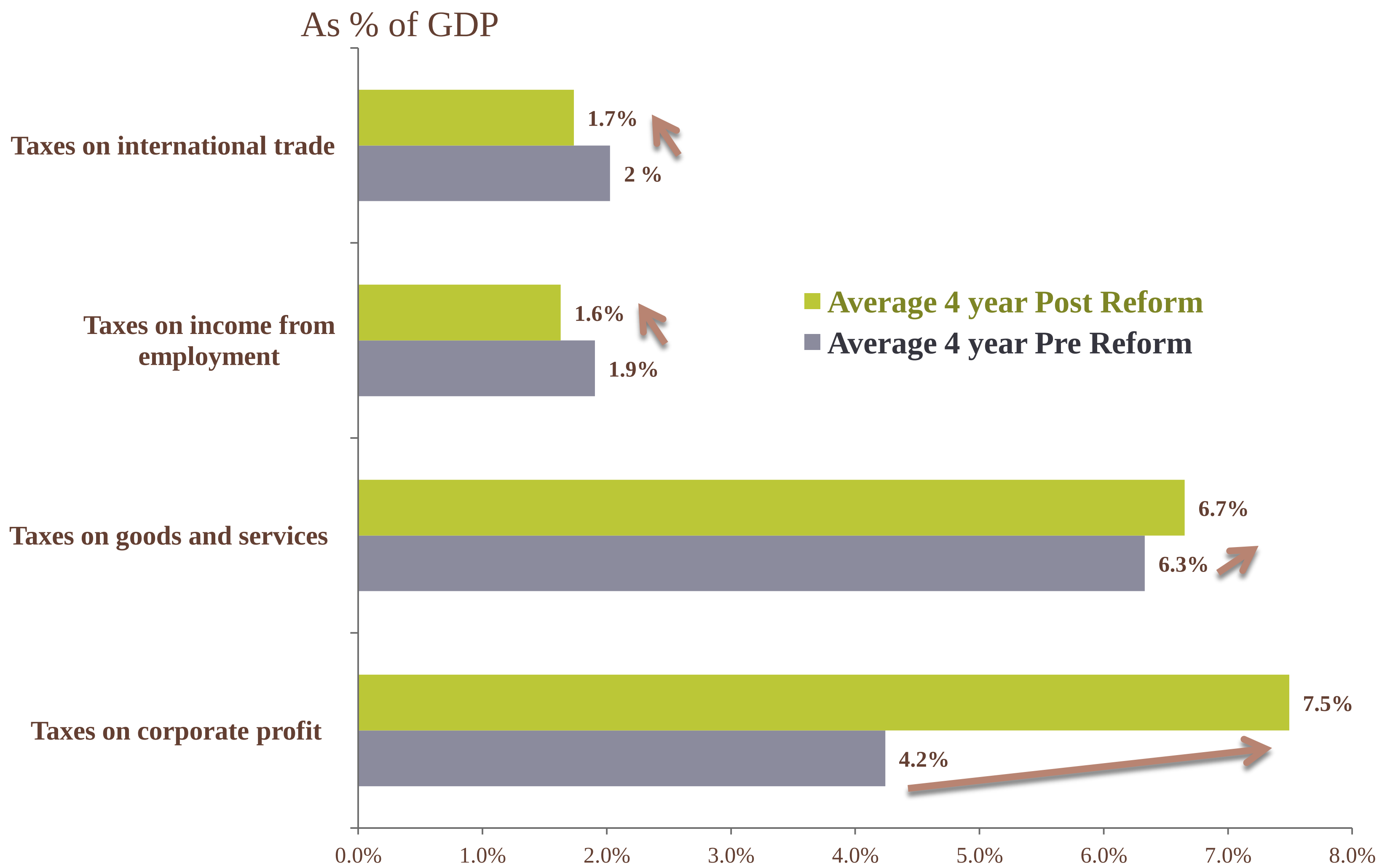
Source: ministry of finance, the financial monthly Bulletin.

Consistently, in the year following the reform, taxes on corporate profits surged from 5.2 percent of GDP in the year prior to the reform to 6.6 percent, while other tax revenues declined.



Source: ministry of finance, the financial monthly Bulletin.

Improvement in corporate taxes was solid over an extended period, averaging 4 years pre and post-reform.



Source: ministry of finance, the financial monthly Bulletin.

To recognize the effect of tax reform on corporate tax base, sample of 70 corporate income statement were selected from KOMPASS in various sectors (firm selection was based on available data).

Sector	No. of firms	Average tax base pre-reform	Average paid tax pre-reform
Banks	15	187,253	49,389
Oil, Gas & Mining	2	226,697	65,664
IT & Communication	2	1,335,774	400,553
Trade & Distribution	1	34,540	8,907
Chemical &Paper Products	6	174,039	35,620
Engineering & Household Goods	5	85,385	11,892
Real Estate Investment	23	282,114	70,096
Investment & Holding Companies	1	57,263	4,713
Pharmaceuticals& Health Care	8	53,925	9,448
Tourism & Entertainment	2	59,537	2,867
Textiles, Clothing & Leather	5	139,802	20,866

Source : calculated using KOMPASS data which presents financial and business profile for 151 companies including all CASE 30, the most actively traded stocks, as well as all banks and insurance companies, 9TH Edition Year Book of KOMPASS.

Evidence indicates that in spite of reducing the effective corporate tax rate, increased corporate tax base led to an increase in corporate taxes revenues post the reform.

Effective Corporate Tax Rate

$$\frac{Corporate\ Taxes}{Profits\ before\ taxes}$$

Weighted Average of Corporate Tax Base

$$\frac{Number\ of\ firms\ in\ the\ sector}{Total\ number\ firms} * Tax\ Base\ of\ the\ sector$$

Weighted Average of Corporate Taxes

$$\frac{Number\ of\ firms\ in\ the\ sector}{Total\ number\ firms} * Sectoral\ Taxes$$

	Effective Corporate Tax Rate	Weighted Average of Tax Base	weighted Average of Taxes
Pre-Tax Reform (2004)	22%	1,416,503.6	358,268.2
Post-Tax Reform (2006)	14%	3,332,304.4	588,377.1

Source : calculated using KOMPASS data which presents financial and business profile for 151 companies including all CASE 30, the most actively traded stocks, as well as all banks and insurance companies, 9TH Edition Year Book of KOMPASS.

In general , corporate tax revenues increased post tax reform, reflecting tax base growth, in line with increased investment and output.

Sector	Effective Corporate Tax Rate: Pre- Reform (2004)	Post-Reform (2006)	Pre-Post	Growth of sample Corporate Tax Base	Sample Investment Growth	Sector output growth *
Banks	30%	8%	21% ⇩	80% ⇧	6% ⇧	4.8% ⇧
Oil, Gas & Mining	29%	11%	18% ⇩	135% ⇧	7% ⇧	5.9% ⇧
IT & Communication	28%	18%	9% ⇩	80% ⇧	143% ⇧	11% ⇧
Trade & Distribution	26%	21%	5% ⇩	46% ⇧	0.4% ⇧	4.8% ⇧
Chemical &Paper Products	17%	13%	4% ⇩	9% ⇧	68% ⇧	
Engineering & Household Goods	14%	10%	4% ⇩	254% ⇧	19% ⇧	2.9% ⇧
Real Estate Investment	23%	18%	5% ⇩	9 % ⇧	21% ⇧	8.9% ⇧
Investment & Holding Companies	8%	8%	0.1% ⇩	679% ⇧	76% ⇧	
Pharmaceuticals& Health Care	18%	19%	-1% ⇧	63% ⇧	7% ⇧	3.9% ⇧
Tourism & Entertainment	5%	7%	-2% ⇧	282% ⇧	145% ⇧	18.4% ⇧
Textiles, Clothing & Leather	14%	14%	0.1 % ⇩	-24% ⇩	-3% ⇩	

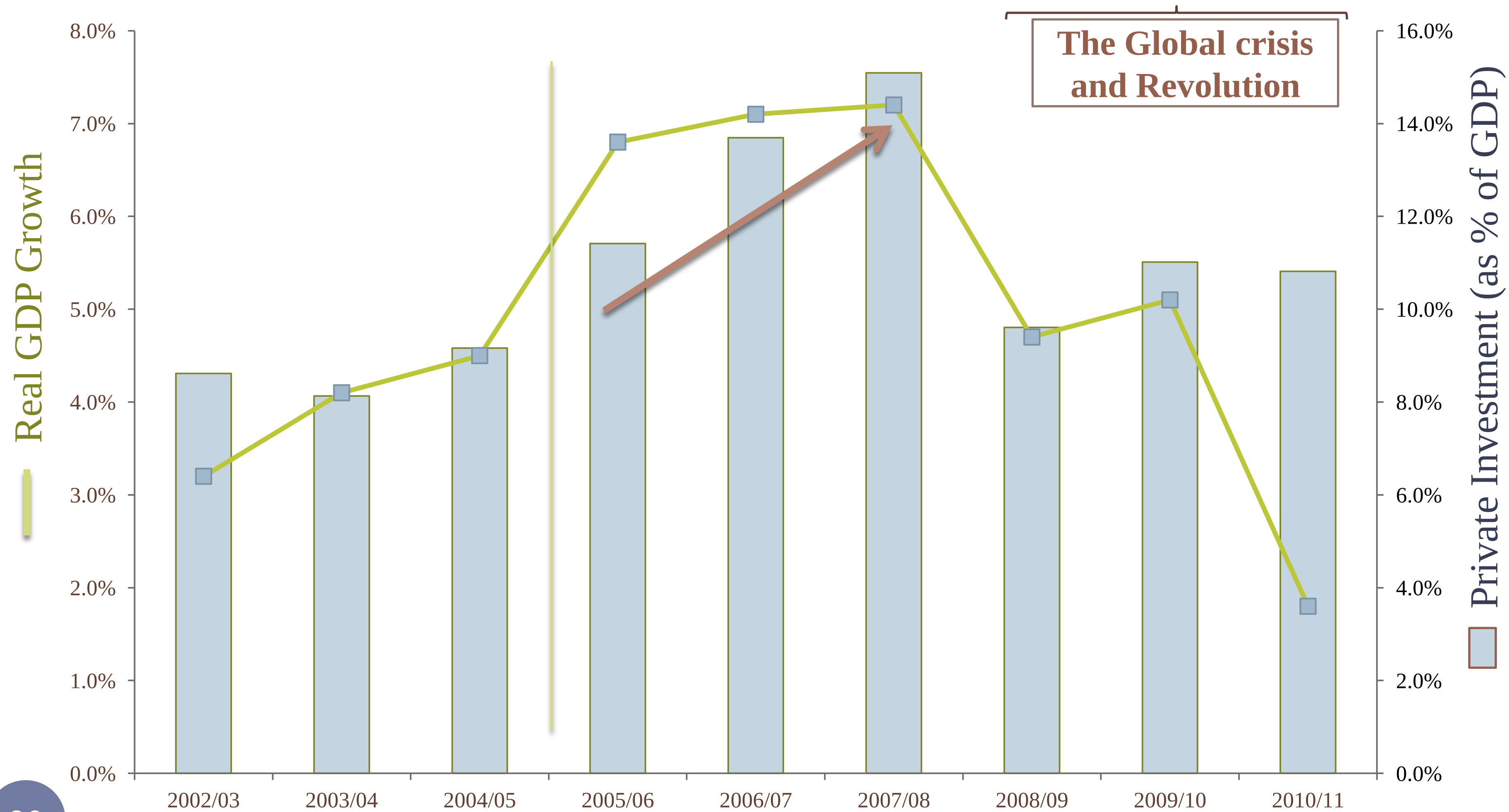
Source : calculated using KOMPASS data which presents financial and business profile for 151 companies including all CASE 30, the most actively traded stocks, as well as all banks and insurance companies, 9TH Edition Year Book of KOMPASS.

* Hassan, Mohamed, and Magda Kandil. "The Relation between Public and Private Employment in Egypt: Evidence and Implications." ECES Working Paper No. 161, June 2011.

Business Environment Post Reform.

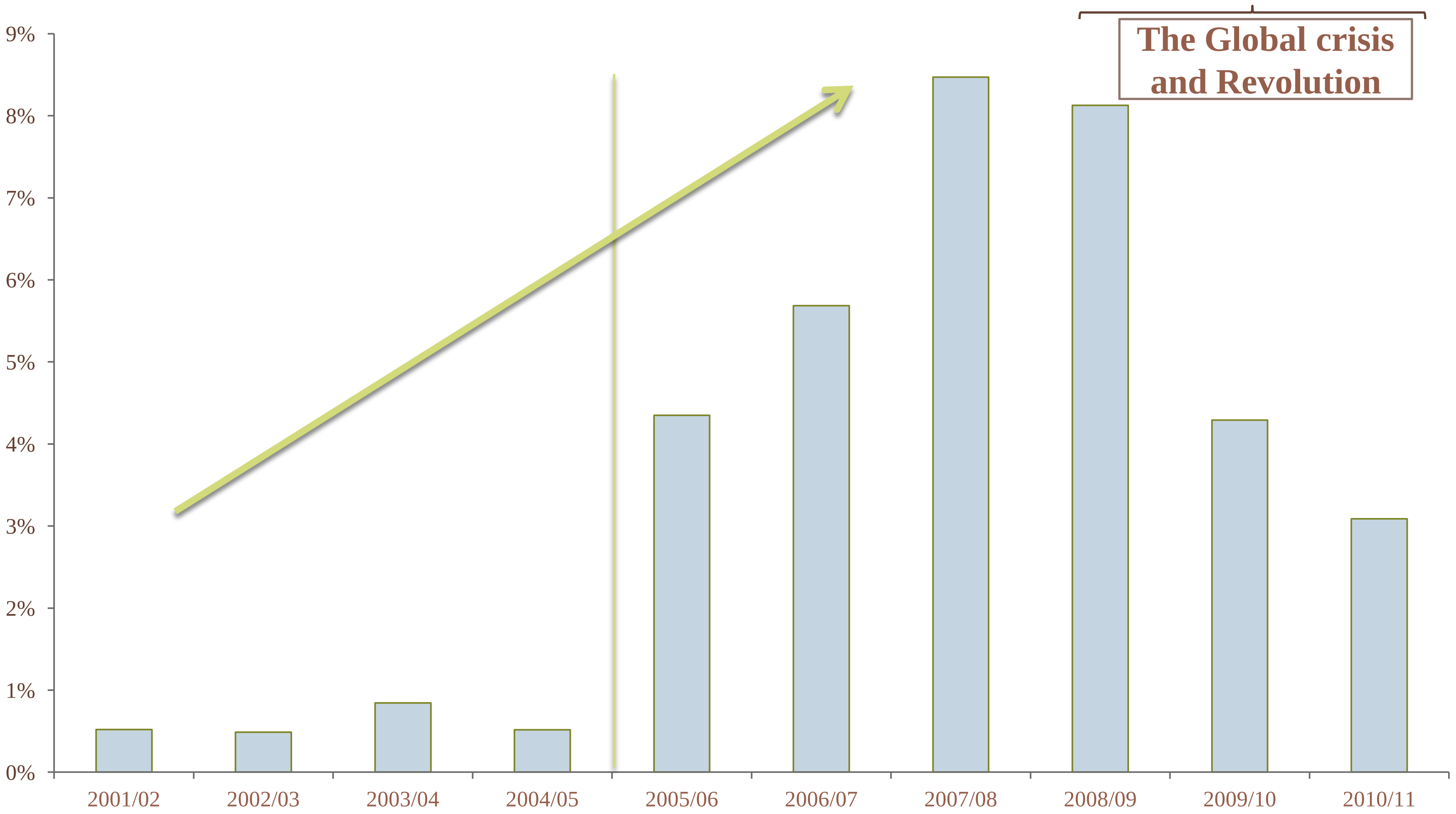
The Business Environment post Reform

Tax reform, coupled with other economic reforms, have paid off to energize private investment and economic growth, reflecting the positive effect of tax reform on the business environment.



Source: ministry of finance, the financial monthly Bulletin.

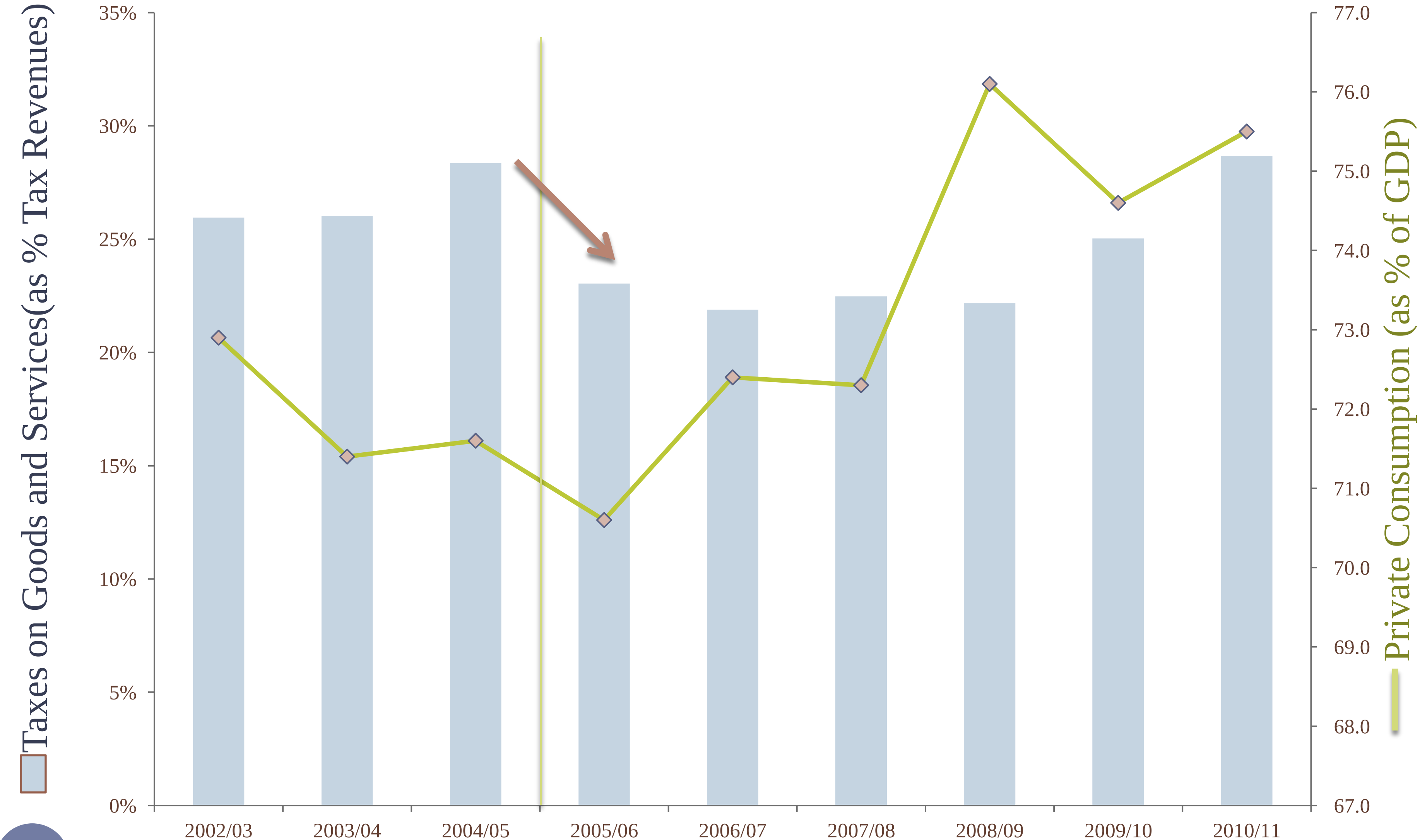
Along the same line, FDI has increased post the tax reform.



Net Foreign Direct Investment (as % of GDP)

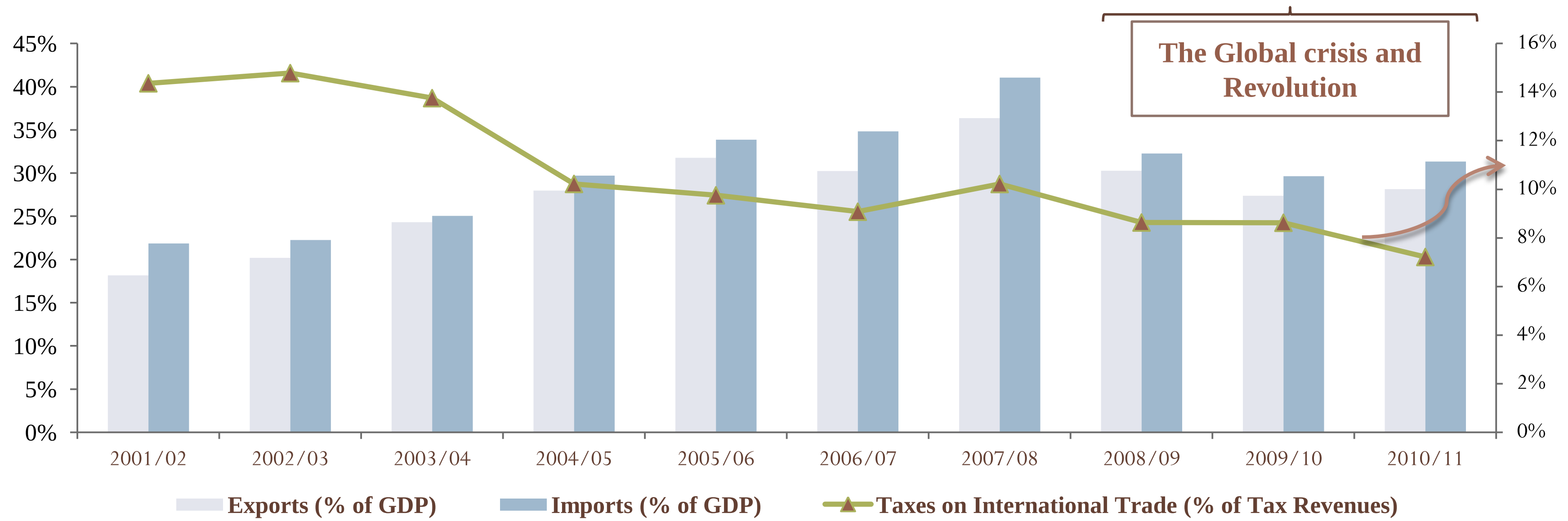
Source: ministry of finance, the financial monthly Bulletin.

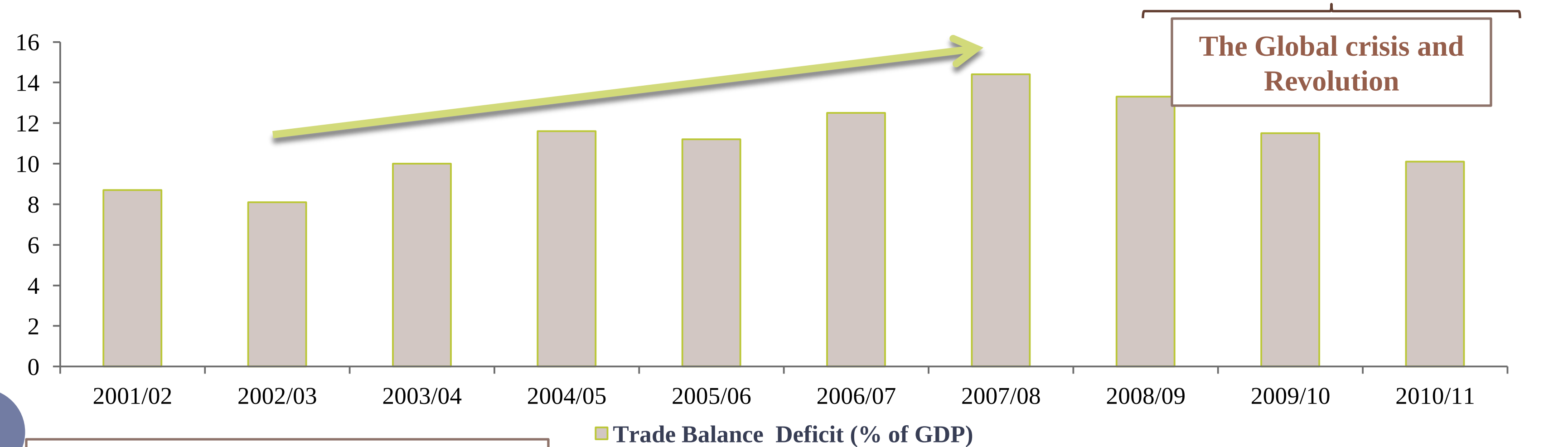
Along with the surge in investment, consumption decreased relative to GDP in 2005/2006, reflecting higher savings. However, increased corporate tax revenues have compensated for the reduction in taxes on goods and services.



Source: ministry of finance, the financial monthly Bulletin.

Customs reforms to match the WTO requirements increased exports as a percentage of GDP. However, reduced customs led to a larger increase in imports, widening trade deficit and reducing international trade tax revenues.





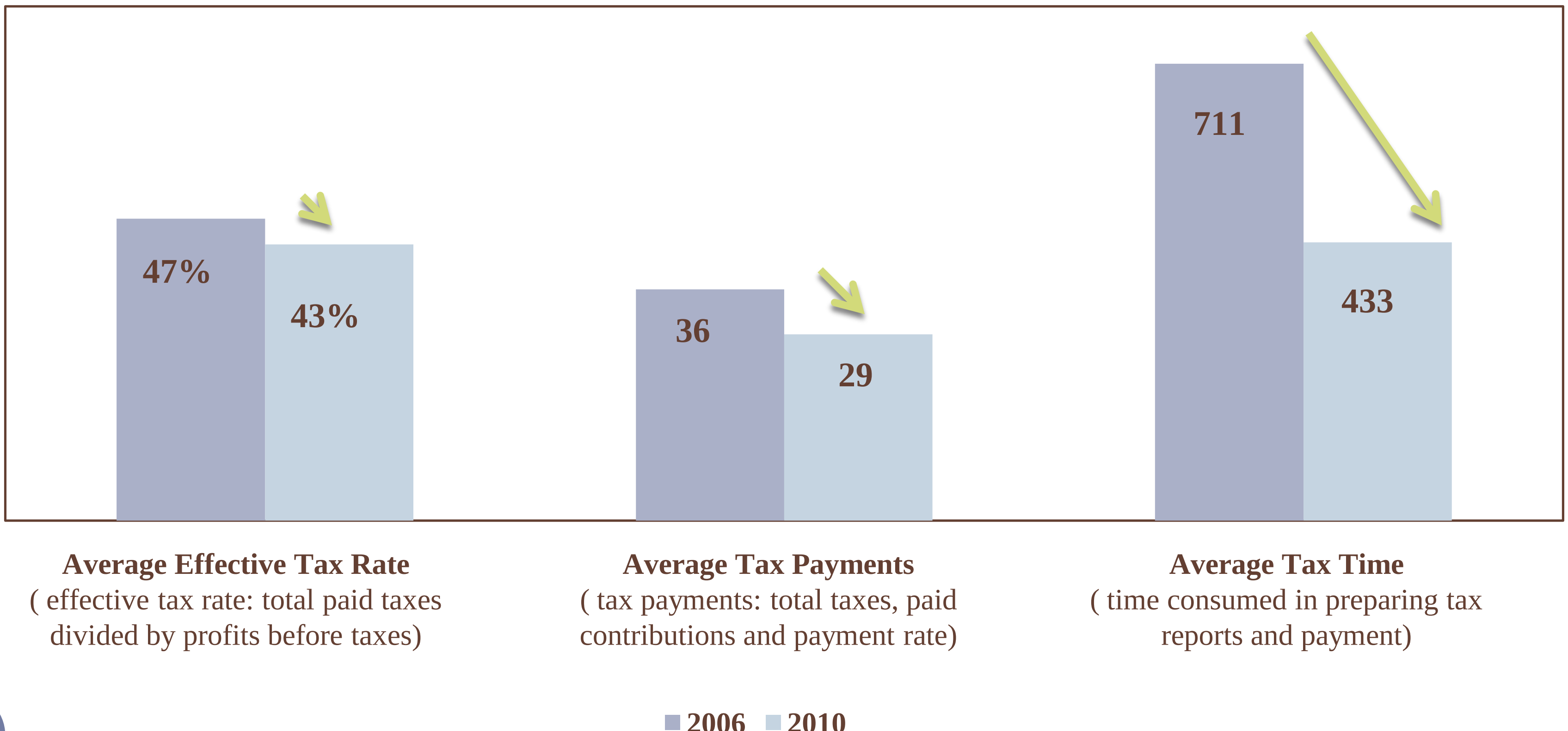
Source: ministry of finance, the financial monthly Bulletin.

Efficiency of tax administration post reform.

Efficiency of tax administration post reform

Based on paying tax reports, the elimination of multiple tax rates helped reducing the effective tax rate and enhanced efficiency and compliance.

However, tax compliance still imposes a heavy burden on business in terms of time, providing incentives for informality and tax evasion.

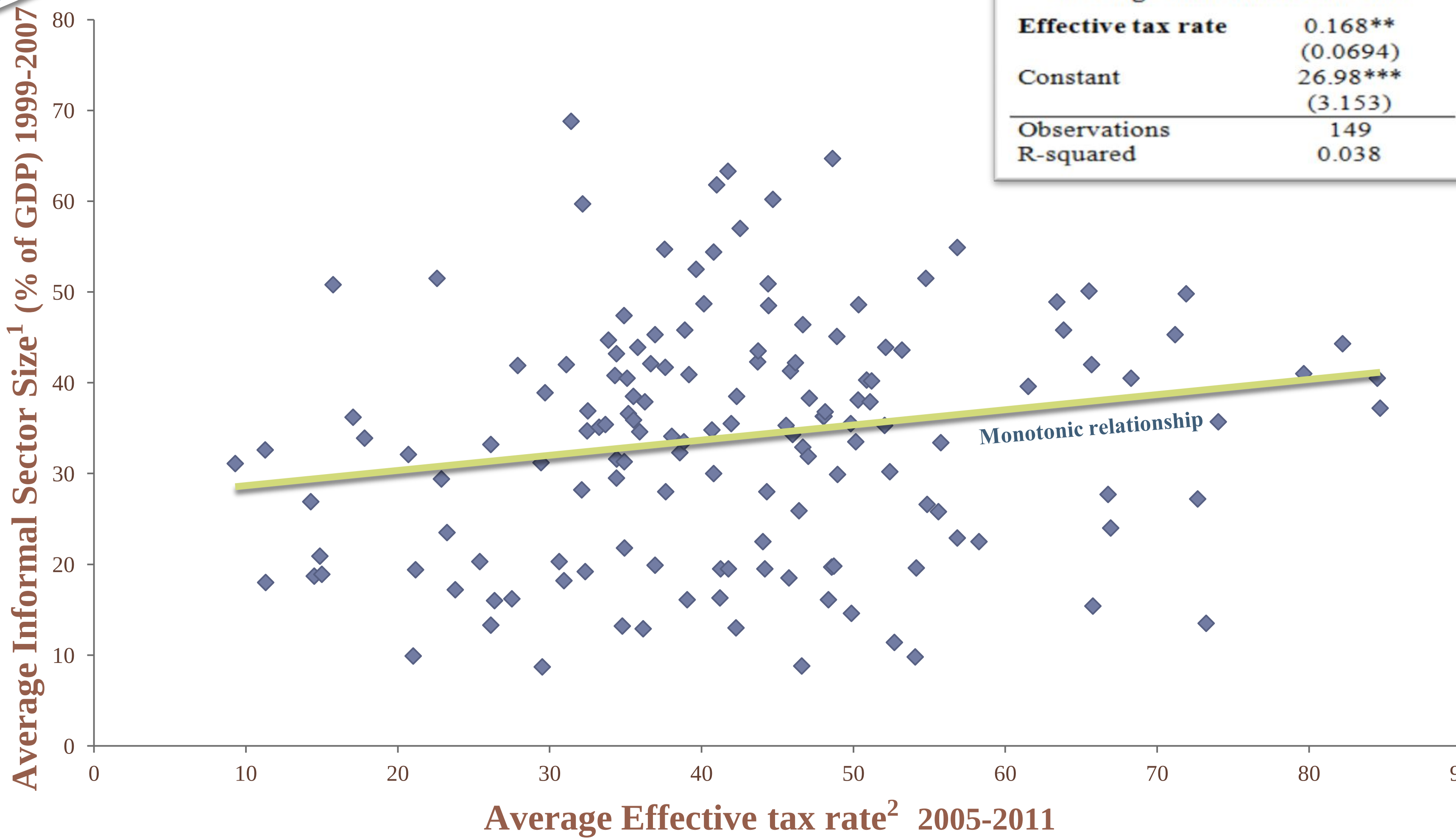


Source: paying tax reports, world bank.

The Tax System and the Informal Sector

The Tax System and the Informal Sector

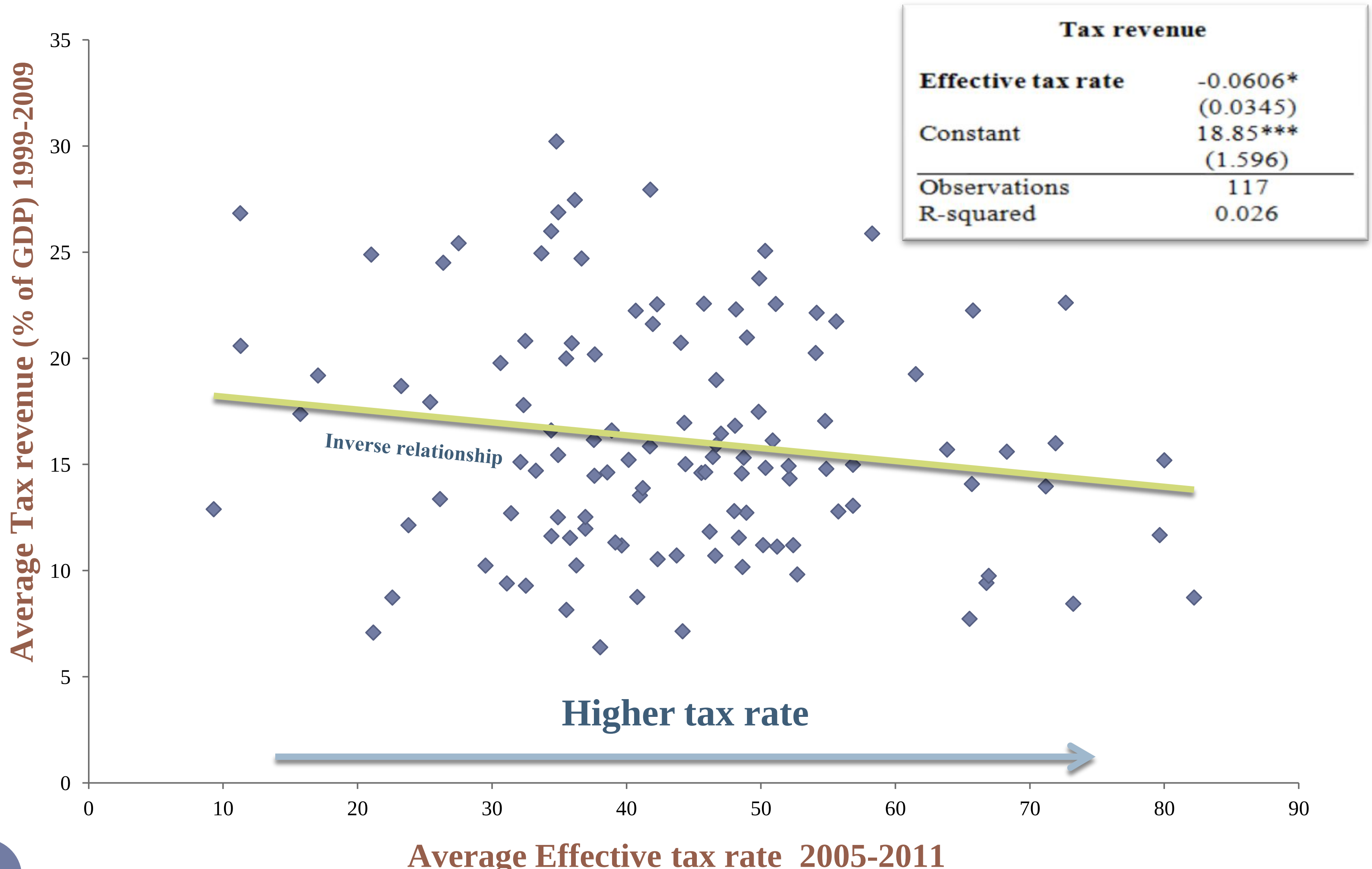
In a cross-country regression, evidence indicates significant increase in the informal sector size with the increase in the effective corporate tax rate.



Average Informal sector Size	
Effective tax rate	0.168**
	(0.0694)
Constant	26.98***
	(3.153)
Observations	149
R-squared	0.038

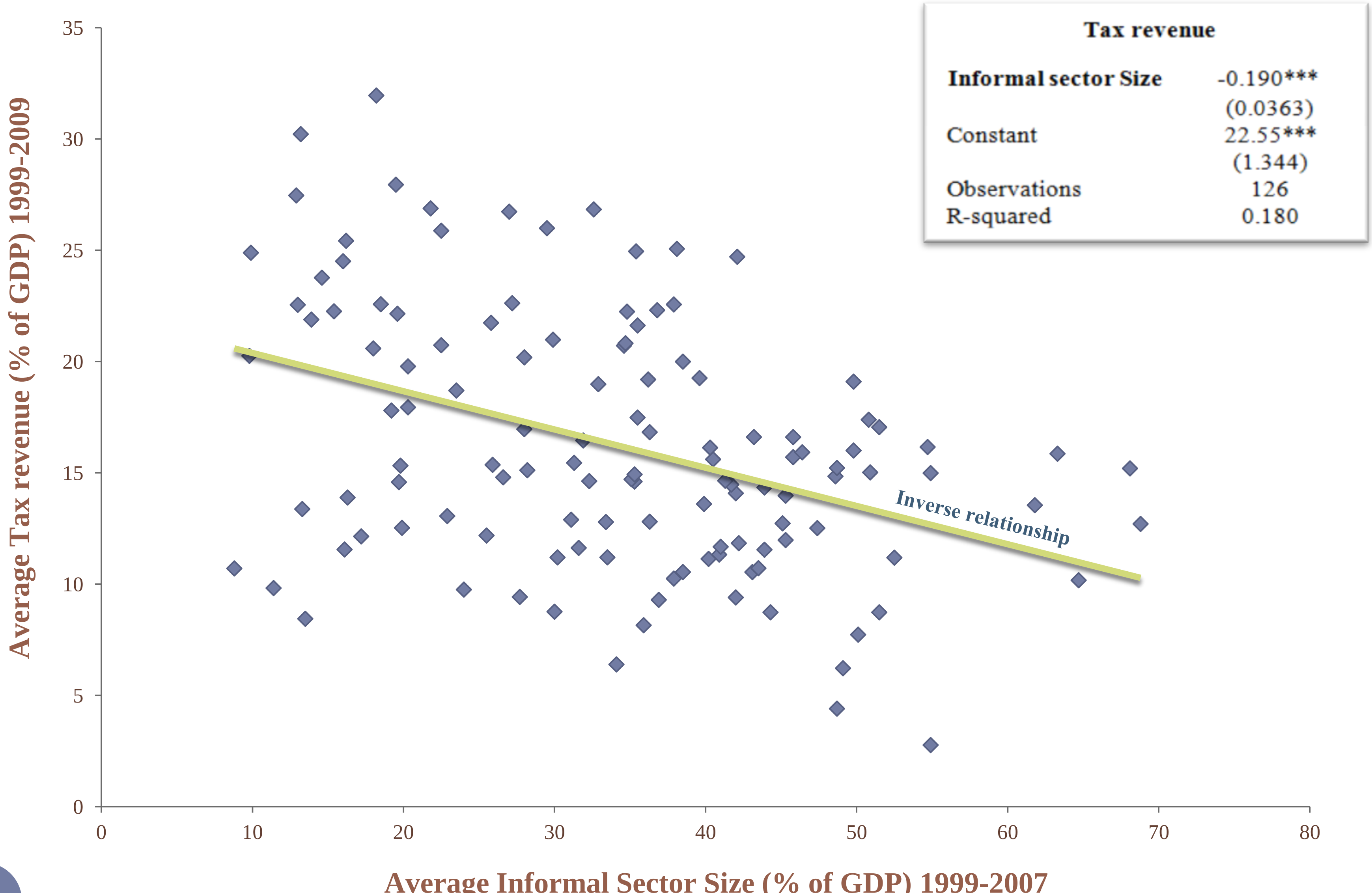
[1] Schneider, Friedrich, Andreas Buehn, and Claudio Montenegro. "Shadow Economies All over the World: New Estimates for 162 Countries from 1999 to 2007." *Human Development Economics Unit, The World Bank*, 2010./ [2] World development indicators.

To reinforce the point, the increase in the effective corporate tax rate results in significant reduction in tax revenues to GDP, reflecting larger size of informality in a cross-country regression.



Source: world development indicators.

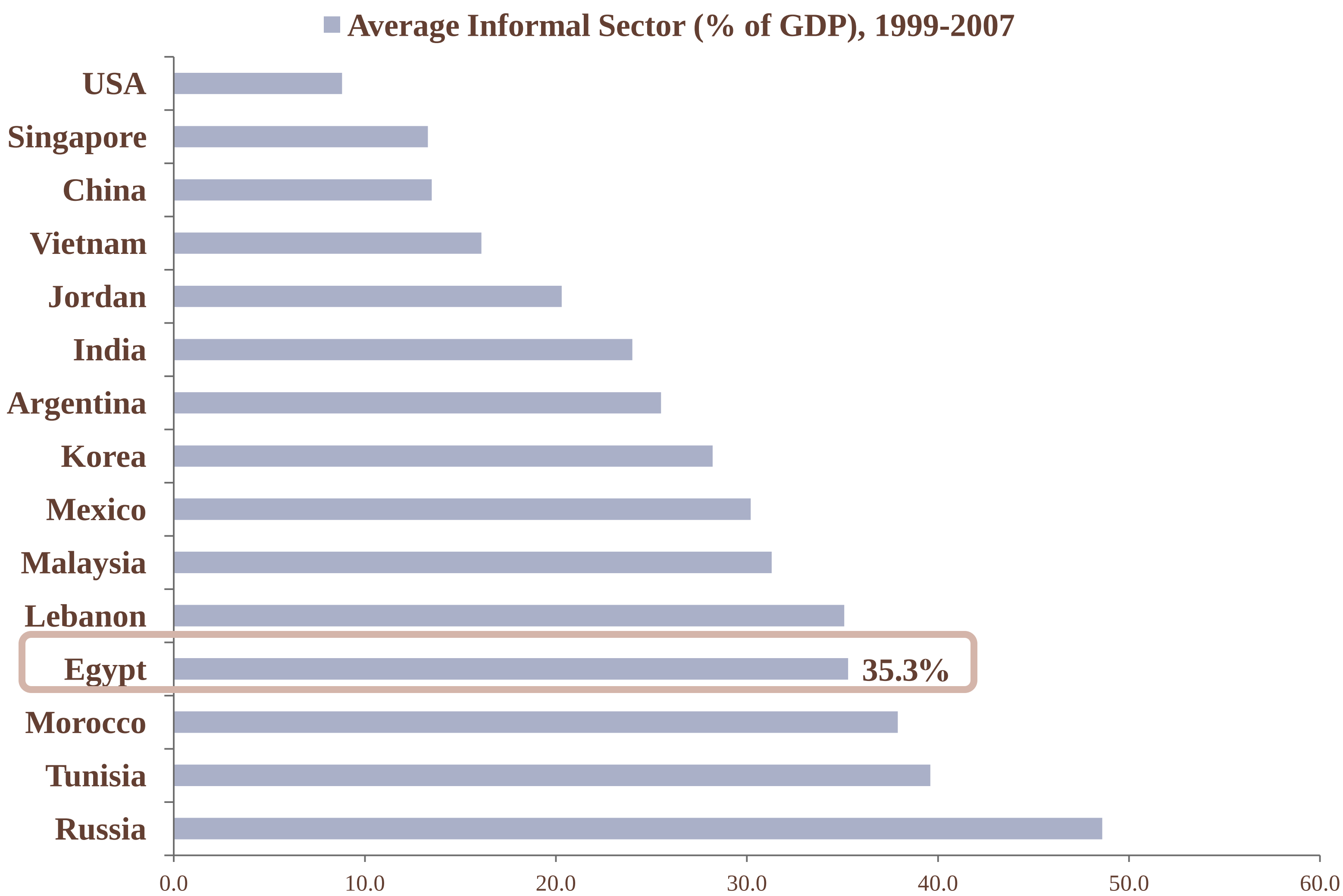
In the same vein, evidence from a cross –country regression indicates significant reduction in tax revenues, as share of GDP, with an increase the informal sector size.



In the context of Egypt, the informal sector has been growing in size over time, shrinking revenues that could be available to the government in the context of a growing economy.

Schneider, Friedrich, Andreas Buehn, and Claudio Montenegro. "Shadow Economies All over the World: New Estimates for 162 Countries from 1999 to 2007." *Human Development Economics Unit, The World Bank*, 2010.

The informal sector as a percentage of GDP is high in Egypt, compared to other countries, negatively affecting tax revenues.



Schneider, Friedrich, Andreas Buehn, and Claudio Montenegro. "Shadow Economies All over the World: New Estimates for 162 Countries from 1999 to 2007." *Human Development Economics Unit, The World Bank*, 2010.

International Experiences with flat tax

- **The case of flat taxation in Russia compared to Egypt**
- **Egypt’s indicators in international context**

Lessons from International Experiences: Russia Flat Tax

The Russian Flat Tax Reform

Higher Budget Deficit

12.4 % of GDP in 1998

Large Size of the Informal Sector

46% of GDP in 2000

Higher Tax Evasion estimated to

34 % of tax revenues in 1998

These indicators pushed the Federal Government towards tax reforms to mobilize tax revenue by widening the tax base and increasing incentives for more formality.

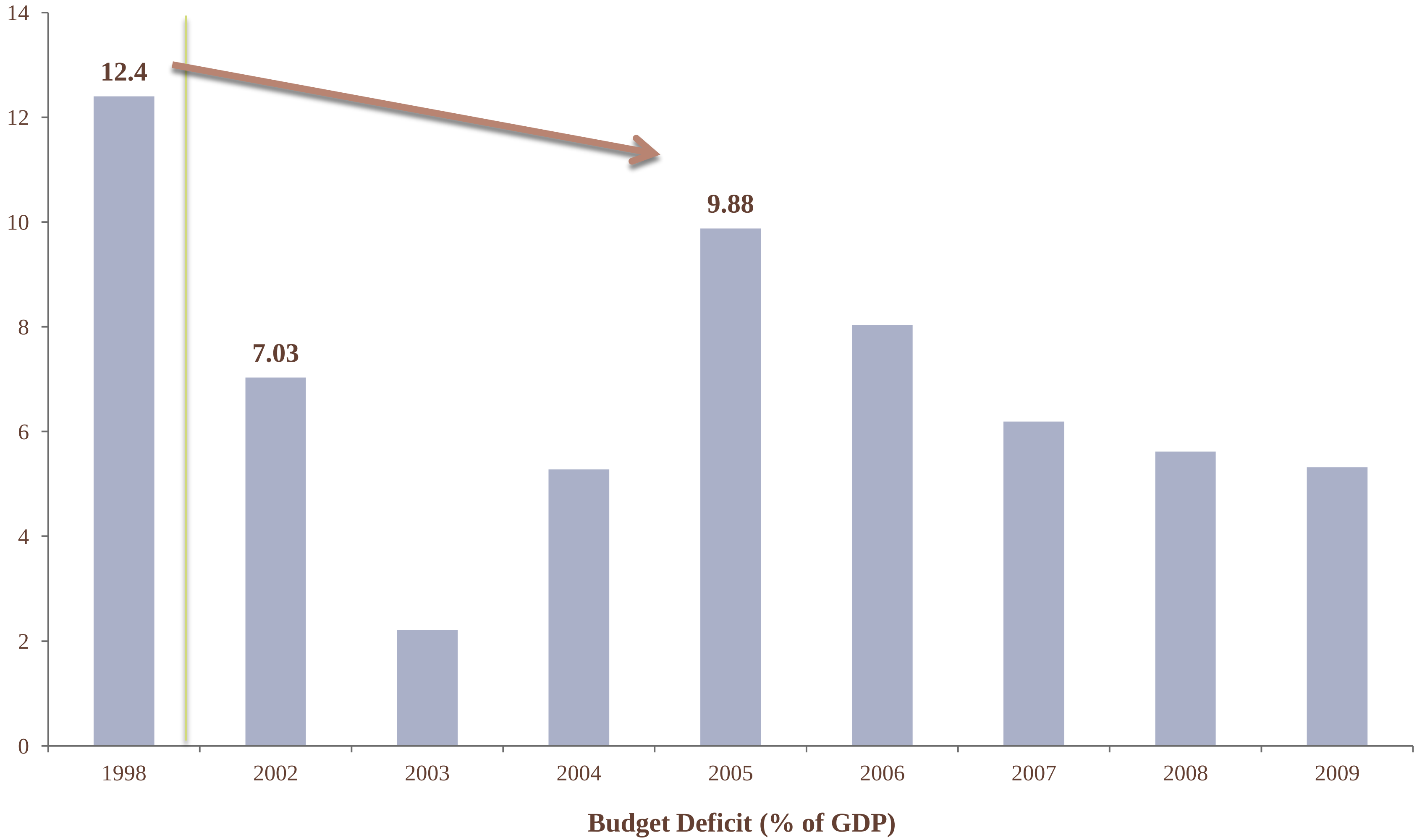
Tax reform procedures in Russia

- **Early 2001, Russia unified its marginal rates of personal income taxation at the flat rate of 13 percent (previously it was at 12, 20, and 30 percent).**
- The corporate tax rate remained flat at 30 percent.
- **The tax rate on dividends increased from 15 percent to 30 percent.**
- **Tax reforms aimed at widening the tax base by eliminating many deductions and exemptions, and reducing incentives for evasion.**

Following the reform in 2001, personal income tax revenues in nominal value increased by about 46 percent, and by around 0.5 percent of GDP.

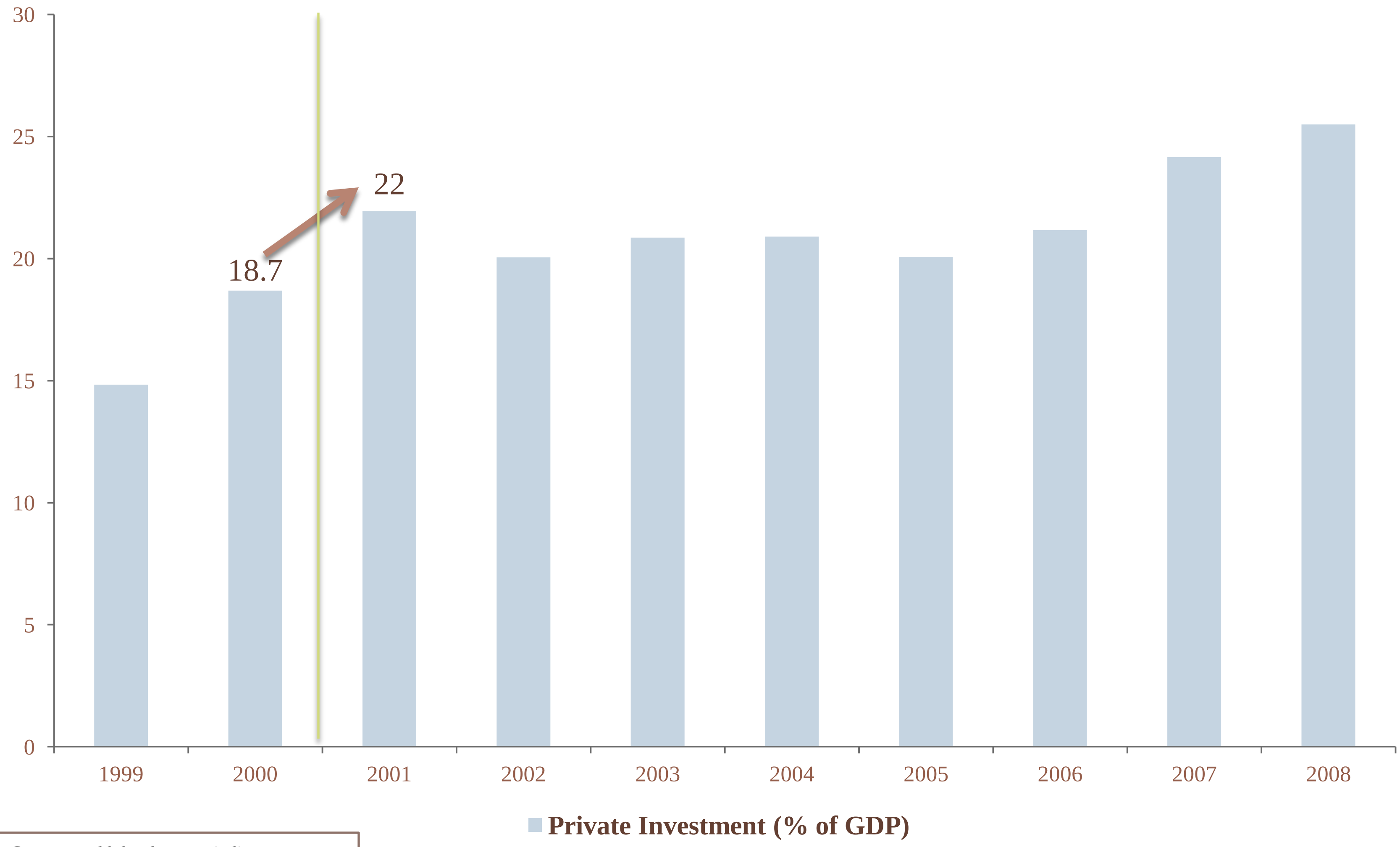
Ivanova, Anna, Michael Keen, and Alexander Klemm. "The Russian Flat Tax Reform." *IMF* WP/05/16 (2005)

Mobilizing tax revenues post reform helped reduce the budget deficit in Russia as percentage of GDP from 12.4 in 1998 to 7.03 in 2002.



Source: world development indicators.

Immediately after enforcing the flat tax in 2001, private investment increased to 22 percent of GDP.



Source: world development indicators.

Further, Research concluded that the 2001 Russian flat rate income tax **reform has been credited with large increases in tax revenues and an improved business climate.**

- **Underling the successful evidence to mobilize revenues following the Russian tax reform,** the evidence confirms that **tax evasion has decreased in Russia significantly**, especially for taxpayers that experienced the largest decrease in tax rates after reform, attesting to *a positive relationship between (lower) tax rates and (less) tax evasion*..

Hence, there is further scope to combat tax evasion in Egypt towards mobilizing additional tax revenues.

Gorodnichenko, Yuriy, Jorge Martinez-Vazquez, and Klara Peter. "Myth and Reality of Flat Tax Reform: Micro Estimates of Tax Evasion Response and Welfare Effects in Russia." Journal of Political Economy 117, no. 3 (2009).

Other countries followed Russia

- Following Russia's adoption of the personal income flat tax, Ukraine's parliament approved its own 13 percent flat tax on personal income in 2004, compared to previous rates ranging from 10 to 40 percent .

- Unfortunately, tax revenues fell significantly following reform **(why?).**

- Many other countries followed the same scenario, yet their tax revenues fell significantly following reforms (why?).

Flat taxes work better where there is strong evidence of informality, tax evasion and incentives for economic and business activity.

In Russia, the economy was plagued by higher degree of Tax Evasion. Hence, the flat rate income tax reform led to substantial revenue gains via increases in voluntary compliance, widening the tax base and increasing tax revenues.

Ivanova, Anna, Michael Keen, and Alexander Klemm. "The Russian Flat Tax Reform." IMF, 2005.

Egypt vs. Russia post reform

Egypt (2005 reforms)

Corporate income tax

Pre reform	34%,42%
Post reform	20%

Personal income tax

Pre reform	20%, 27%,32%, 35% and 40%
Post reform	10%, 15% and 20%

Russia (2001 reforms)

Corporate income tax remained

30%

Personal income tax

Pre reform	12%, 20% and 30%
Post reform	13%

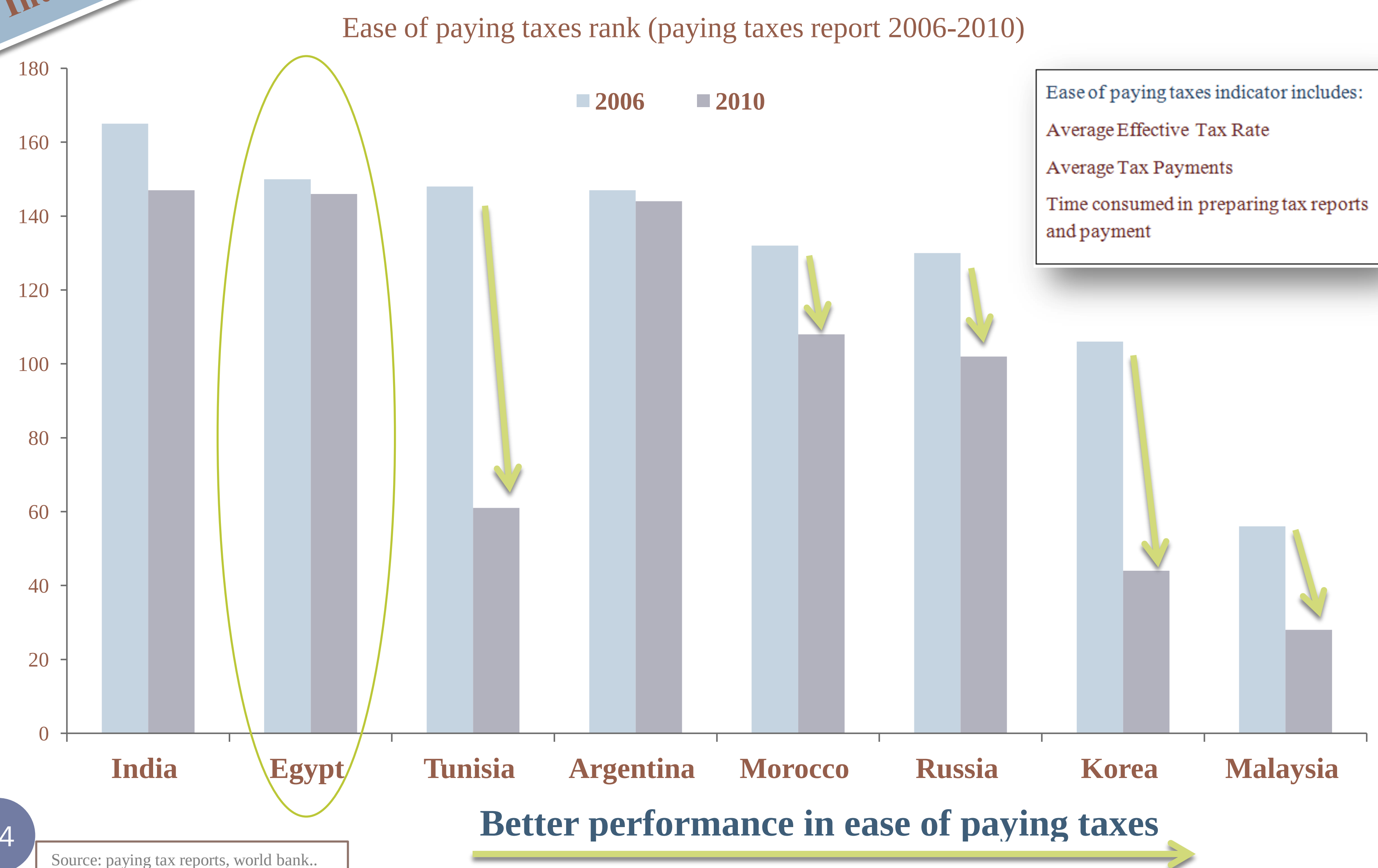
		Egypt	Russia
Economic Growth	Pre:	4.5	-4.9
	Post:	6.8	5
Private Investment (as % of GDP)	Pre:	9.2	18.7
	Post:	11.4	22
Fiscal Deficit (as % of GDP)	Pre:	9.6	12.4
	Post:	8.2	7.03
Tax Revenues (as % of GDP)	Pre:	14	36.9
	Post:	16	37.5
Corporate Tax Revenues (as % of GDP)	Pre:	5.2	
	Post:	6.6	No change in the rate
Personal Income Tax Revenues (as % of GDP)	Pre:	2.2	2.4
	Post:	1.3	2.9

Egypt’s indicators in international context.

Conclusion: there is scope for more reforms to support the economic activity and increase tax revenues in Egypt

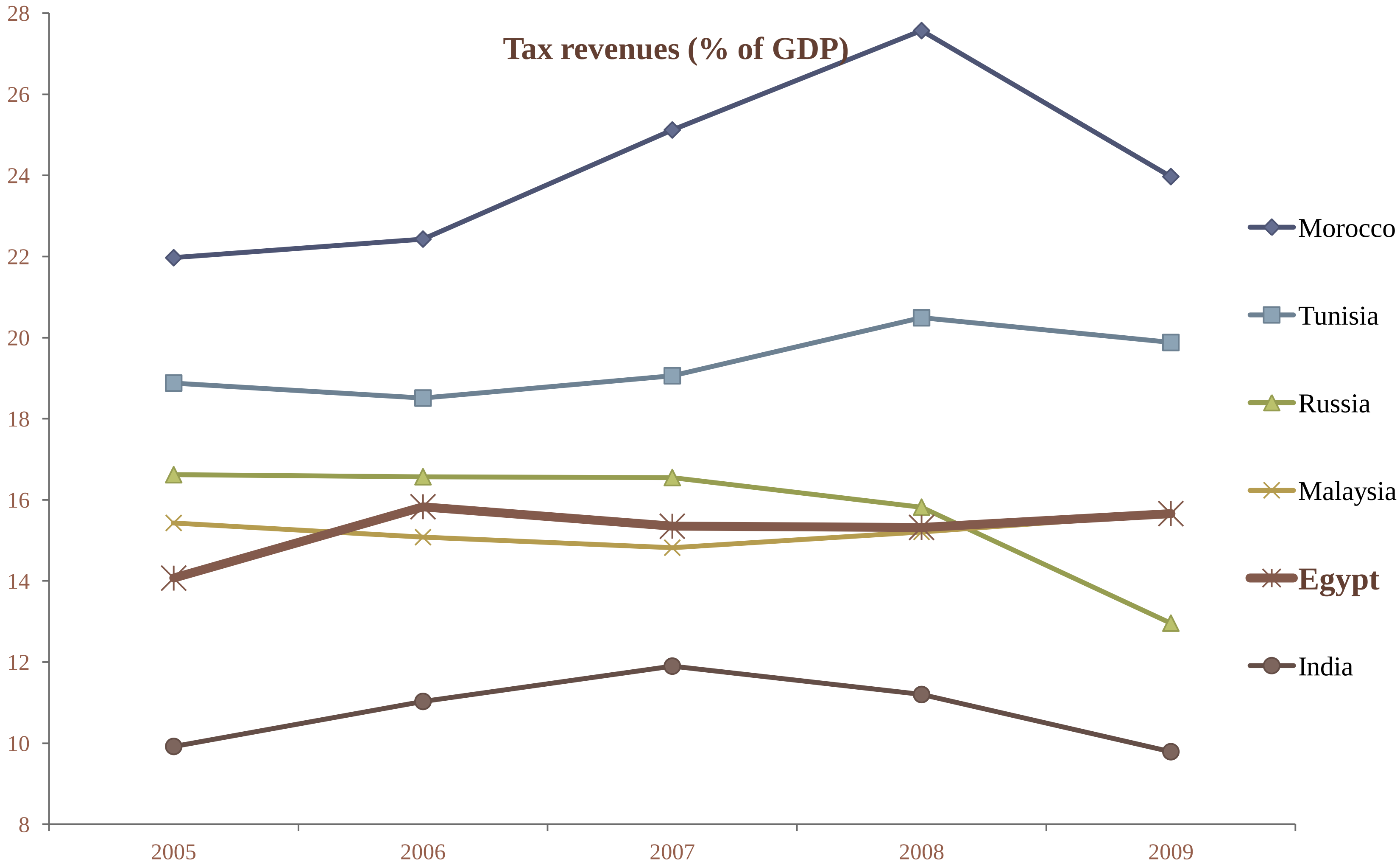
Egypt's Tax Progress in International Context

In international context, Egypt has improved slightly in terms of ease of paying taxes. However, it still significantly lags behind other countries regarding ease of paying taxes.



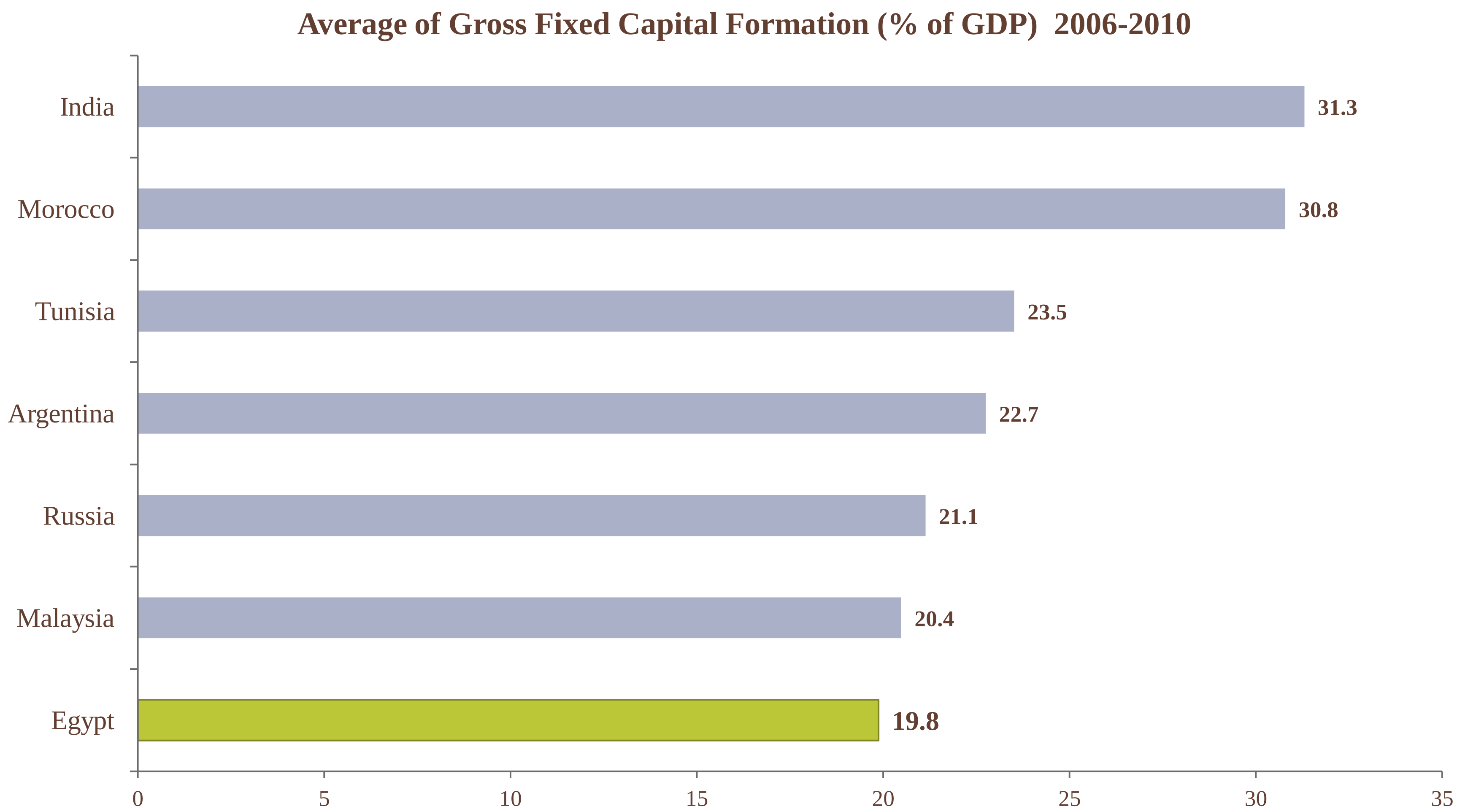
Source: paying tax reports, world bank..

In the same vein, tax revenues relative to GDP remain low compared to other countries, suggesting a scope for more tax reforms towards mobilizing additional government resources.



Source: world development indicators.

Compatible with the poor performance of the taxation system, Egypt's investment is the lowest, relative to GDP. Hence, future reforms are necessary to mobilize investment.



Source: world development indicators.

Conclusion: to mobilize higher tax revenues under a flat rate system:

There should be incentives to encourage economic activity and increase investment to ensure higher rates of employment particularly if labor supply is elastic as is in Egypt

Increase incentives for formalization

Reduce tax evasion

Increase tax base, and hence tax revenues

Successful flat rate tax objectives

Increasing tax revenues

Stimulating economic activity