USAID ASSISTANCE IN FISCAL REFORM

COMPREHENSIVE TAX REFORM IN EGYPT

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EGYPT

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I. PROJECT DATA

Level of Funding: $60 million / $23 million

Periods of Assistance: 1989-97, 1999-2004 / 2005-2009

Types of Assistance:
1. Technical Assistance
2. Materials, Equipment and Facilities
3. Training

Areas of Assistance:
1. Tax and General Economic Policy Analysis and Forecasting
2. Tax Administration
3. Pension Reform
4. Debt Management
5. Treasury and Budget Reform
6. Institutional and Organizational Development

Main Counterparts:
1. Ministry of Finance, Office of the Minister
2. Egyptian Tax Authority (formed by merger of the Income Tax & Sales Tax Departments, April 2006)
3. Large Taxpayers Center (and interim Model Customs and Tax Center)

II. THE PROJECT: BACKGROUND, PRINCIPAL RESULTS AND IMPACT

Introduction

Since the late 1980s, USAID has provided more than $80 million in assistance to the Government of Egypt (GOE) to reform its tax system, strengthen its institutional capacity to administer taxes, and build analytic capacity to design and implement fiscal, and especially tax, policy. This assistance has been provided through a combination of international and national long-term and short-term technical assistance, technical and systems design, engineering assistance in the design and implementation of new work-flow stations and facilities, training in-country and abroad, training of trainers, international observation travel, and the procurement of computers, servers, and other automated data processing devices.

Primary USAID assistance in the tax area was provided through two projects, Public Finance Administration and Corporate Tax Projects, which together spanned some 15 years, from 1989 to 1997 for the former and from 1999 to 2004 for the latter The first project, working with international and Egyptian experts, analyzed all aspects of taxation, simulated the impacts of policy change on revenues and economic and social sectors, and investigated the legal and administrative aspects of taxation and tax compliance. The project also produced a very comprehensive volume referred to as the “Redbook”, which presented to the (then) Minister of Finance a comprehensive tax reform program for the Government. Indeed, many of the recommended reforms were enacted in the 1991-94 period. Policy and institutional reform is a particularly challenging endeavor and the USAID team devoted considerable time and effort to sustaining a dialogue with Egyptian leaders on the importance of reforms and the consequences of not undertaking them. These efforts are still yielding results.

In October 2005, USAID resumed its tax assistance to the GOE with the launch of the Technical Assistance for Policy Reform II (TAPR II), which runs through 2009. However, the sections below focus more on the outcomes and impacts of assistance provided under the earlier USAID project.

A. *Background and Economic Context of the Project*

Although taxation only generates about two-thirds of the Government’s revenues—the rest derives directly from the oil sector and charges on Suez Canal traffic—the importance of taxes in the development of the private sector, as well as in financing overall public sector spending, cannot be overstated.

Tax revenues in the early 1980s reached almost 25% of GDP, but were on a secular decline (led by the income tax) and had dropped to less than half that share by 1989/90. When USAID’s Corporate Tax Project began, the GOE’s overall fiscal deficit was quite high at 17.7% of GDP in 1990/91, and the tax ratio (tax collections as a percentage of GDP) was low. With USAID’s assistance, the GOE managed to reduce the deficit to less than 1.5% of GDP by 1995/96 and raise the tax ratio to more than 16.5%. From a policy perspective, two of the most important reasons or the performance improvements were the introduction of the General Sales Tax (GST) in 1991, and the Global Income Tax in 1993, both with USAID support. The new taxes led to transformations in the Egyptian tax system, and to the establishment of a new institution and the modernization of the country’s tax administration.[1] With the income and sales tax regimes in place, USAID helped its GOE counterparts with sweeping changes that broadened the tax base,

[1] In July 2005, the GOE enacted a new income tax law, which took effect from the beginning of the same year. The new law and its impact are discussed briefly in a section on ‘Recent Developments’ below.

automated and strengthened tax enforcement, increased professionalism in the tax service, and brought greater clarity to the tax rules and regulations. Particularly successful areas of assistance are briefly described below.

B. *Outcomes and Impacts in the Project's Principal Areas of Assistance*

1. Sales Tax

When the Public Finance Administration Project began, Egypt had roughly 150 different "consumption taxes," essentially excise taxes collected *ex fabrica* from about 4,000 different firms, and from imports. The structure of the consumption taxes provided considerable protection to domestic industry by placing a high effective tax rate on imports. The consumption tax not only discriminated against foreign competition, but its application was also unclear and its rates were highly varied; thus, it left the door open to confusion and to unequal treatment of taxpayers.

With USAID assistance, the Government of Egypt consolidated this set of taxes, moving toward more uniform taxation with few rates and reduced discrimination between domestically produced and imported goods. The General Sales Tax replaced a sales tax regime with myriad rates, imposed mainly at the factory level, with a broader based tax on sales. The GST was initially levied at the manufacturing level but was later extended to the wholesale and retail levels. It allowed for the crediting, in part, of the tax paid on inputs and for a zero rate on exports. As under a VAT, participating firms report their sales and purchases every month and are allowed a credit for inputs to their production, against the sales tax revenues collected on their final sales.[2]

The introduction of the GST in 1991 reduced economic distortions that historically hurt Egypt's international competitiveness, such as the cascade effect that distorts prices and the disincentive to export. To implement such a GST, the USAID assistance team helped the Government of Egypt design, staff, train, and create the Sales Tax Department, essentially a brand new organization, to replace the old Consumption Tax Department. In the first year of operations, the Sales Tax Department registered about 25,000 firms, but over time, and with the extension of the tax to the wholesale and retail level, more than 140,000 firms have become active sales tax participants. This broadening of the base was essential not only to revenue generation, but also to increase fairness and enhance tax compliance. The Sales Tax Department manages what was then the single most important tax in the country.

The GOE plans to upgrade the current Sales Tax—moving much closer to a true Value Added Tax system and raising the threshold to except small businesses—in 2007, to eliminate most of the weaknesses which remain under the current regime.

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[2] This is very similar to the VAT, but there are still a few weaknesses, such as allowing only very limited crediting for capital goods inputted into the production process.

2. Income Tax

USAID assistance was also pivotal in modernizing the country's income tax, beginning initially with more effective income tax administration. Through the Public Finance Administration Project, USAID played an instrumental role in modernizing the Income Tax Training Institute, automating many income tax processes, and simplifying the income tax system, leading to more equitable treatment of income taxpayers than in the past. Prior to the reform of 1993, a schedular system of income taxes treated salaries, professional fees, corporate dividends, and many other income sources in a variety of disparate ways and imposed an inconsistent set of rates. The income tax reform led to a more coherent definition of the tax bases, broadened the tax base (while at the same time relieving an estimated 3 million lower-income earners of tax liability), and reduced extremely high marginal tax rates to more reasonable rates. For instance, the top commercial income tax rate dropped from 78% to 48% and the top rate on wages from 71% to 32%.[3]

USAID assistance to the Income Tax Department beginning in the early 1990s included training, organizational development, establishment of the Income Tax and the Computer Training Centers, policy advice, provision of computers and automation of processes.

During the subsequent Corporate Tax Project of 1999-2004, USAID advisors analyzed the income tax law and provided a set of recommendations for a more thoroughgoing and comprehensive reform, in order to further reduce complexity in the income tax system and raise voluntary compliance,.

In July 2004, HE Dr.Youssef Boutros Ghali was appointed Minister of Finance, bringing energy and enthusiasm to Egypt's tax reform agenda. Under his leadership, and with support from the International Monetary Fund, the Ministry of Finance adopted a sweeping tax reform strategy that revolved around three key themes: (i) a modern legislative framework for taxation, (ii) integration of the Sales and Income Tax Departments into a single, functionally-organized tax authority, and (iii) management of taxpayers by segment—i.e. large, medium and small.

A key early milestone was the enactment of a new Income Tax Law in June 2005, which took effect from the beginning of that year. The new law embraced many of the recommendations made by USAID's Corporate Tax Project. The new law

[3] "These top marginal tax rates combine the Schedular Tax, the General Income Tax, and the Development Duty, but adjust for the fact that the Schedular Tax and the Development Duty are deductible under the General Income Tax." See *Egypt: Public Finance Administration Project Final Report*, Barents Group, 1998.

- cut tax rates by more than half to a maximum rate for both individuals and corporations from 42% to 20%, and it introduced revalorized tax brackets of 10% and 15%;
- raised the non-taxable threshold to LE 5,000 (roughly 60% of 2004 per capita income in Egypt) and eliminated many of the wide-ranging exemptions available under the previous law; and
- introduced a self-assessment system for individuals and corporations alike.

Shortly after the income tax law was introduced, USAID resumed tax assistance with the Government of Egypt through the Technical Assistance for Policy Reform (TAPR II). Through TAPR II, USAID set to work on supporting implementation of the new law, drafting materials and holding workshops for the key Income Tax Department staff responsible for implementing the new policy, and developing internal procedural instructions for receipt and processing of the new income tax returns.

To help the Income Tax Department implement self assessment, TAPR II assisted in revising the executive regulations to reflect the relevant changes, drafted a complete guide to self assessment, and assisted in setting up Taxpayer Service Units at all district and regional tax offices. Through TAPR II, USAID also co-funded the Ministry of Finance's ongoing public education campaign to enhance public awareness of the income tax changes and to promote self-assessment. The mass media campaign contributed to a 40% increase in the number of income tax returns filed in the first four months of 2006 compared to the same period in 2005.

Despite the substantial reduction in tax rates, combined income tax revenue from enterprises and individuals reached an estimated 6.0 percent of GDP in 2005/06 – up from 5.0 percent of GDP in 2002/03. Income tax collections thus have equaled or exceeded revenue from the GST.

3. Administrative Development and Reorganization.

Model Customs and Tax Center. Toward improving efficient handling of large taxpayers, USAID assisted the MOF during 2002-05 to develop a Model Customs and Tax Centre (MCTC). The MCTC provided a "one-stop shop" for large taxpayers who opted to participate in the new system, allowing them to receive and file tax forms, make tax payments, and deal with auditors and examiners for all their tax matters (including customs payments) through one office. The MCTC was set up to enable joint audit of customs and taxes, with full current accounts for all taxpayers in the system, and to perform all the basic tax administration processes (e.g., taxpayer services, returns processing, accounting, audit, and document management).

The MCTC opened its doors in June 2003, with nearly 300 large taxpayers already on its rolls by the end of that year. Participation in the MCTC was open only to taxpayers of a minimum size, subject to a variety of taxes, located in the Cairo region, and classified as importers. Importantly, MCTC participation was voluntary. Yet once taxpayers saw that participation in the MCTC greatly facilitated their trade and tax compliance, the number of participants grew very rapidly. For the MCTC importers, customs clearance was reduced to about a day compared to the seven days or more that was required for most other importers.

At the recommendation of the International Monetary Fund, the MCTC was phased out in September 2005, replaced on the tax side by a fully integrated Large Taxpayers Center (LTC) and on the customs side by a series of Modern Customs Centers (MCCs) with operations at Egypt's key ports and other points of entry. The LTC handles tax administration for the 2,000 largest taxpayers, accounting for roughly 70% of total Egyptian tax revenue.

Integration and Restructuring of Tax Departments. In April 2006, the Government announced plans to integrate the Income and Sales Tax Departments into a single, unified Egyptian Tax Authority, inheriting more than 60,000 employees from its predecessors. A presidential decree was issued appointing the former head of the Sales Tax Department as head of the new body. To support an expected MOF plan for downsizing and rationalization of the operational office network, USAID's TAPR II consultants have done considerable preparatory work to support change management, including design of organization and staffing, a strategy for internal and external communications, and design of an IT solution for the integration.

III. FACTORS OF SUCCESS

A number of factors contributed to the success of the USAID assistance.

1. Engagement and Sustained Support of Reform Champions. Forging partnerships with champions of reform is fundamental to success, especially in moving forward aggressive and controversial reforms. Over nearly two decades, USAID has established a very strong relationship with the Ministry of Finance, and more recently with the new Minister and his team of advisors, as well as the Sales Tax Commissioner, who has been nominated to head the newly integrated Egyptian Tax Authority. Engagement of these and other reform champions since the inception of USAID assistance has helped to ensure sound implementation and long-term commitment from all players.

2. Comprehensive Approach to Reform. Tax policy reforms are unquestionably important, but the critical component of a successful tax reform program is the establishment of an effective, efficient and fair tax administration. Hence, the dual focus on policy and administration proved to be imperative in addressing challenges and ensuring harmonization among various tax policies as well as among different procedures of implementation.

3. Long-term Commitment of USAID. USAID has provided technical and material assistance to the Ministry of Finance since 1989 to streamline its overall fiscal mandate. When US assistance began in 1989, the GOE had neither a policy reform agenda nor a clear plan for the modernization of tax administration. USAID assistance worked to develop policy analyses, undertook considerable effort to familiarize Egyptian counterparts with the analytical rationales, was able to produce a set of policy and administrative reforms that the GOE was willing to implement—quickly in the sales tax area, more slowly for the income tax. Institutional capacity building was an important aspect of the USAID programs, improving the ability of Egyptian counterparts to develop and implement its own reform agenda. Increasingly, the MOF is now using its own resources to procure international and national technical assistance as well as equipment to ensure sound implementation of their reform agenda. Importantly, USAID's willingness to provide a long-term commitment recognized that the political and cultural change needed to support tax reform in a large, stable country does not happen in the short term.

4. Flexibility of USAID Project Administration. Flexibility enables project assistance to adapt to the changing needs and priorities of its counterparts and rise to new challenges as they emerge. During the initial stages of USAID assistance in 1989-90, tax analysis and policy reform had been scheduled to precede technical work in the tax administration areas. However, the Government found that it was propitious to move more quickly on one aspect of administrative reform, namely scrapping its complicated set of consumption taxes. The consumption taxes were replaced with the much more comprehensive General Sales Tax, and with its introduction a new department had to be established to administer the new tax. USAID's assistance project was able to shift its focus significantly to the implementation of the new General Sales Tax and the creation of the new department. This shift was possible because institutional development and tax administration expertise had already been contracted and could be mobilized quickly to exploit the opportunity perceived by the Government.