

Adding a million taxpayers

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Most tax reforms have 1 goal: increase tax revenues. Egypt is no exception. With a budget deficit in 2004 of £E40 billion, 8.3% of gross domestic product (GDP), Egypt had to reform. Finance Minister Youssef Boutros-Ghali said, “Doing nothing is definitely not the solution. The greatest enemy to reforms is inertia.” Egypt did not stand still. After reform, tax return filings increased nearly 50% and income tax revenues grew as a share of GDP, even with rate cuts.

With 8.2 million people in the informal sector, 37% of the workforce, there was a great opportunity for broadening the tax base and increasing revenues. Tax evasion was the norm, with mutual distrust between taxpayers and tax authorities. Tax rates were high. Egypt charged 32–40% on corporate income, more than twice the 15% in Jordan and Lebanon. And Egypt was the second worst in the region in ease of paying taxes.

In July 2004 a new cabinet took office with a mandate to reform. One of its goals was to increase employment through investment. To do so, a high priority was placed on amending the tax law, customs law, and customs tariffs and on enacting competition and antitrust laws. Making Egyptian tax law closer to international practice would increase Egypt’s competitiveness and its attractiveness as a destination for foreign investment.

The boldest reform would be to simplify tax law so that every business faces the same tax burden—with no exemptions, tax holidays, or special treatments for large or foreign businesses. Many tax laws start that way. But when hard times come and governments need revenue, they often raise tax rates. And large or well connected businesses usually get special treatment. Soon the tax law becomes riddled with exceptions, generally at the expense of small businesses, which have the least ability to lobby. This pushes them into the informal sector.

Eliminating exemptions and reducing tax rates

Few reformers dare eliminate exemptions, reduce tax rates, and clarify tax rules. But Egypt did just this. In June 2005 the Egyptian parliament approved Law 91/2005. Now all companies are equal under the law, paying a 20% tax on profit (not 32% or 40%, depending on the activity, plus 2% as development duty). New tax holidays and special exemptions were eliminated, as was the state development duty. And the rules for multinational companies were improved. Egypt now uses a definition of permanent establishment based on UN convention; new rules for transfer pricing and thin capitalization are in place.

The withholding tax on interest and royalties was reduced from 32% to a 20% flat rate. The calculation of asset depreciation is specific in the new law, unlike previously, when the different rules to compute depreciation gave much discretion to the tax inspector.

The personal income tax was changed through the same law. The highest personal tax rate went from 32% to 20%. All individual taxpayers get an annual tax exemp-

tion of £E4,000. Benefits in kind, such as medical insurance, are now tax exempt. And the tax base now includes residents working abroad and nonresidents working in Egypt.

Taxation administration also improved. Self-assessment replaced administrative assessment, essential for the tax reform. As Boutros-Ghali says, “The point of the new law is to say what you want: whatever claim you make, we believe you, no questions asked, but you will be held criminally responsible and accountable for your claims.” Under the old law, the taxpayer was considered guilty until proven innocent. Now the tax administration trusts the taxpayer.

The tax authority does not examine the tax return at the time of submission. Instead, the authority thoroughly audits a sample of taxpayers within 5 years of submission. A grace period exempted non-registered taxpayers from old taxes due if they registered and paid tax under the new law. And companies can now submit computerized records.

Under the new law there is less room for interpretation, reducing the possibility of negotiating taxes. As Ashraf al-Arabi, the senior tax adviser to the finance minister, says, “Bargaining is not in the deal any more.” Replacing the old system of bonuses for tax collection for inspectors, the punishment for noncompliance was made more severe, and the accountant was made liable for the veracity of tax information. Under the new law, the accountant can go to jail for tax evasion, and fines can go up to £E10,000 (\$1,839). At the same time, the tax appeals process improved to ensure taxpayers’ rights are protected. Taxpayers who overpaid are entitled to a refund within 45 days of the reimbursement application date. The goal of the reform was to make the tax administration more transparent and fair.

Passing the reform

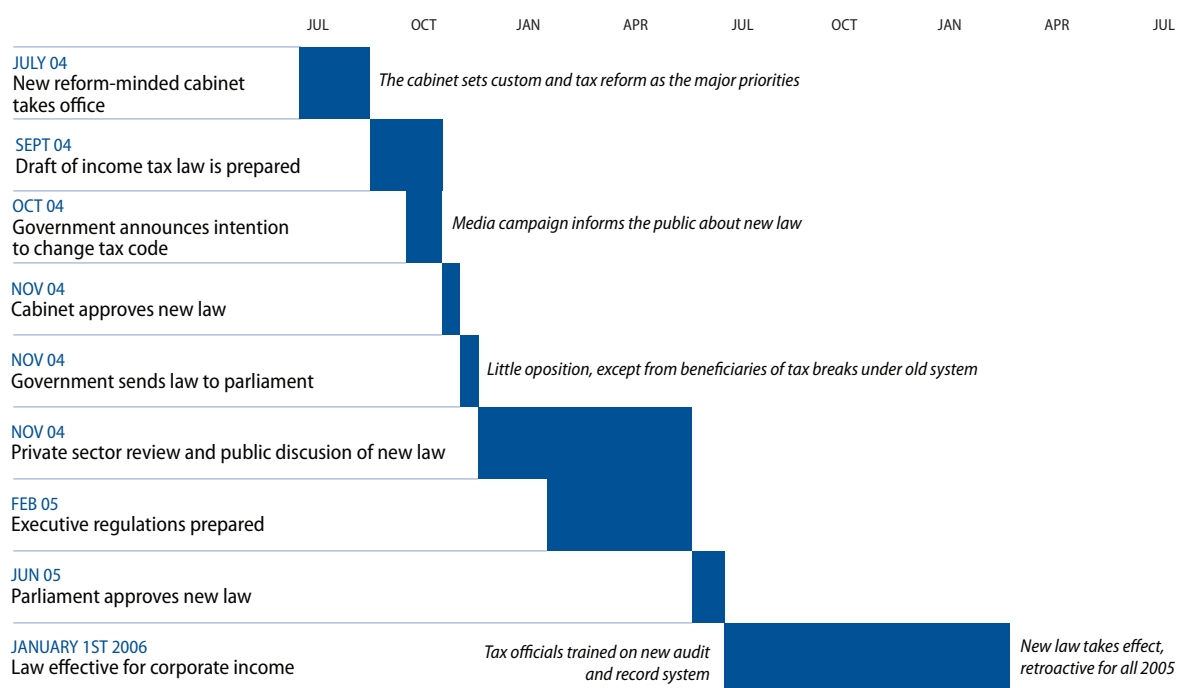
In July 2004 new reform-minded cabinet took office and one of the priorities of the new minister of finance, Boutros-Ghali, was to improve the income tax law. In late August the International Monetary Fund received a request to assist with drafting the new law. It took less than a month to produce the first draft. In October 2004 the government announced the intention to change the tax law to reduce rates and improve tax collection. It also started a media campaign to inform the public about the possible reform. By the end of October the law was finalized.

The law was prepared so swiftly because the finance minister was committed to the project. In November 2004 the cabinet approved the new unified corporate and income tax law. The approved version was distributed to the private sector and to international organizations for review—and sent to the parliament. Roundtables were held with chambers of commerce, major accountants, and taxpayers in the 6 months before the law was passed in June 2005. The law for personal income tax was effective on 1 July 2005 and for corporate income tax on 1 January 2006.

FIGURE 8

Timeline of tax reform in Egypt

Source: Doing Business database.



The reform met little opposition. The public in general agreed that it was needed and was happy with the prospect of lower tax rates. The opposition came from the companies that lost their tax holidays (5 or 10 years of corporate income tax exemption). The major challenge was implementing reform. Along with the reduction in tax rates there was a major effort for administrative reform within the tax authority. Changing from administrative assessment to self-assessment meant a whole new way of collecting taxes. The tax administration was not very supportive because it was unfamiliar with the new system and thought that it had more control under the old system. It had to be convinced that the change was positive, done through training.

More tax revenues—better economic performance

Over 2.5 million taxpayers submitted their tax returns, a significant increase from 1.7 million in 2005, in part because of the amnesty for tax evasion. This number may seem low in a country with 74 million people. But not all taxpayers need to file returns. If the sole source of income is wage income, taxes are withheld at the source.

Taxpayers with income other than wages must file a tax return at the end of the year to declare that extra income. So the 2.5 million taxpayers include only companies and the few wage earners with extra income from a small business. Tax revenues increased, even though the government expected a reduction. Corporate tax revenues went from £E22 billion in fiscal year 2004 to £E39 billion in fiscal year 2005, despite the fall in corporate tax rates (from 32–40% to 20%). Personal income tax revenues

also increased, if marginally, from £E8.1 billion to £E8.3 billion, again despite the drop in rates. Overall income tax revenue increased from 7% of GDP to 9%.

Personal income tax revenues increased both for wage income (6%) and for small business income (4%). Much of the increase in corporate income tax revenue came from the oil sector, which experienced a boom in prices. This is still a positive result for the reform: the tax rate was cut by half and corporate tax revenues hardly fell. So the tax base must have expanded. More companies are complying with the tax system—more than a million more. The time to comply increased from 504 hours to 536 because companies are still adapting to the new system, taking longer this year to prepare, file, and pay corporate income tax.

Egypt's economic performance also improved. Growth in income per capita rose from 2.5% to 4.8%. Domestic investment went from 18% of GDP to 18.7%. The budget deficit was reduced and foreign direct investment increased.

Learning from mistakes

Both taxpayers and tax officers will take time to adapt to the new system. The key is to keep learning from previous mistakes and improve the system. Furthermore, the tax reform is not limited to changing the income tax law only. An extra step was taken in May 2006 when the sales tax department and the income tax department were merged into the Egyptian tax department. With 1 tax authority to deal with, companies do not have to double their efforts to pay taxes. The government has also proposed changes to the sales tax law. The momentum of successful reform creates room for further reform.

The new law changed the tax collection system profoundly. Taxpayers used to be told what to pay. Now they compute that themselves. Some found it difficult to complete the tax forms. For instance, the form for companies with an accounting system is 46 pages long. Mistakes were common. Several sections of the form were left blank just because the taxpayer did not know how to fill it out. Nor were tax officers fully prepared to explain how the forms should be completed.

The solution was to extend the filing period to the end of July, then to the end of November 2006. The extensions allowed people to correct previous mistakes without having to pay a fine. The lesson: have more direct contact with taxpayers and answer their questions.

Prepare for implementation: the training of tax officers was not timely. It occurred in batches and new training courses were started even as late as October 2006. On the positive side, tax officers' lack of knowledge about the law was identified, and the tax authority is trying to solve the problem. The new law brings more sophisticated concepts, such as thin capitalization or transfer pricing rules, which are more difficult to implement.

The new residence-based system is more complex than the previous source-based system, so training is essential. A training center for tax administration will be operating in mid-2007. With the self-assessment system, tax inspectors become tax auditors. Rather than assess the tax due, they accept the calculation done by the taxpayer and audit a few taxpayers based on risk assessments. But they need training to become adept auditors. As of March 2007 a tax audit manual was still under development to help tax auditors. Lesson learned—prepare tax officers well, because they are an essential part of implementing the reform.

The Ministry of Finance first drafted and approved the law, then developed executive regulations to implement it. These regulations are a workbook that clarifies the new tax law, an essential piece of tax reform implementation. After that came the tax forms and the awareness campaign and training. The Ministry of Finance has learned that this may not have been the right sequence. Both the training and the awareness campaigns would have been more effective if started earlier.

Still a long way to go

Both the public and the government have a positive view of the reform. Sherif Hassan, owner of a medium-size business, says, “I used to pay 40% of profits, now I pay 20% and I do my own tax assessment. I don’t have to wait for the tax inspector to tell me what to pay. Of course, I’m happy with this reform.” The government sees better economic performance, higher tax revenues, and happier businesses.

Other countries can learn from Egypt’s experience. The focus was on attracting new taxpayers into the system, accomplished by lowering tax rates, simplifying tax compliance, reducing the discretionary power of tax inspectors, and seeing the taxpayer as acting legally, but imposing harsh penalties otherwise. Other countries with large informal sectors can use this reform as a template for broadening the tax base and increasing tax revenues.

Mahmoud Mohieldin, the minister of investment, says, “Egypt has taken strides in the right direction by introducing these reform actions. However, we still have a long way to go, maybe another 15–20 years before Egypt can accomplish the more difficult task of eliminating illiteracy, improving health conditions, and introducing democratic governance.”