CORPORATE TAX ACTIVITY
FINAL EVALUATION

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LIST OF ACRONYMS

ADP	Automatic Data Processing
CTA	Corporate Tax Activity
DT2	Development Training 2
GDP	Gross Domestic Product
GOE	Government of Egypt
GST	General Sales Tax
GSTACS	General Sales Tax Administration Computer System
IRM	Information Resource Management, USAID
ITACS	Income Tax Administrative Computer System
MCTC	Model Customs and Tax Center
MIS	Management Information System
MOF	Ministry of Finance
PFAP	Public Finance Administration Project
USAID	United States Agency for International Development

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EXECUTIVE SUMMARY

The Corporate Tax Activity (CTA) is the title of the last five and a half years of USAID/Cairo's sixteen-year program of assistance to reform and modernize virtually all aspects of taxation in Egypt. Under the first phase, "Public Finance Administration Project" (PFAP), progress was made in reforming the income tax, but the most important reform was the introduction of the General Sales Tax (GST). The CTA, begun in 1999, was designed to deepen the reform effort in the income tax, to extend the GST to the wholesale and retail sectors and to expand the GST coverage of services. In addition, the CTA contained substantial resources to improve tax administration organizationally, managerially and technically. Finally, the CTA provided a significant amount of next generation computer hardware and software, essential to the operation and management of a modern tax system.

As required by its Scope of Work, the contractor, BearingPoint, initially conducted a detailed analysis of the policy and administrative context of the income tax, as it existed in 1999. By June 2000, a two volume comprehensive policy and administrative reform program was presented to the Ministry of Finance. For the next year and a half, extensive discussions and further analysis of income tax policy were carried out between the MOF and BearingPoint and a draft new law was finalized and approved by the Cabinet for submission to the Peoples' Assembly in 2002.

Unfortunately, the Peoples' Assembly was unable to schedule its debate of the proposed legislation in the 2002 session due to the press of other legislative priorities. Again, in 2003, other legislative priorities took precedence on the calendar. In fact, as of the time of this evaluation, the tax reform bill had not yet been released from the Cabinet's Office for discussion in the Parliament Council. Therefore, income tax policy, as embodied in law, remains unchanged from that prevailing at the start of the CTA.

On the organizational side, a comprehensive re-engineering of the [income tax] Tax Department was proposed but, to some extent, became linked to the passage of the tax reform bill. That is, the MOF was reluctant to proceed with the proposed reorganization simultaneously with the effort to legislate tax policy reforms. Consequently, the Tax Department remains essentially the same organization as that prevailing at the start of the CTA.

Nevertheless, skill levels and management reports have improved as a result of the CTA's training and development of the MIS. A new department has been started to provide information and assistance to taxpayers. In addition, the Tax Department is now approximately 50 percent computerized. Finally, important work has been done to develop a risk assessment model that will become the basis for the Tax Department to shift to a selective audit approach in its review of tax returns.

In contrast to the above, greater progress toward CTA objectives is evident in the Sales Tax Department. As a new department created under the prior PFAP, the Sales Tax Department was more developed organizationally and operationally than its sister [income tax] Tax Department. Consequently, the CTA's initial activity was preparing the Sales Tax Department for the significant expansion of the taxpayer base that was expected to result from the inclusion of the wholesale and retail sector. The preparation was completed early in the project and the tax was legally expanded on July 1, 2001.

At the time of this evaluation, there has been no further expansion of sales tax coverage to services that were not included in the original 1991 legislation. However, this is not a significant shortcoming since the potential value of the not included, but taxable services, is relatively small compared to the wholesale and retail sector.

The CTA has instituted new procedures for filing returns, payments and initial review of returns. These have improved efficiency within the department and eased the burden on taxpayers. However, the MOF has not yet accepted a number of CTA recommendations related to inputs crediting that would make the GST a full Value Added Tax.

The CTA provided substantial training to transfer sophisticated technical skills as well as to strengthen the career-development training program managed by the Sales Tax Department. As in the [income tax] Tax Department, the CTA provided next generation computer hardware and software and in combination with the MOF's own purchases, the department is now approximately 75 percent computerized.

The most innovative development supported by the CTA was the establishment of the Model Customs and Tax Center (MCTC). The concept had not emerged at the start of the CTA but resulted from a CTA financed tour of European tax facilities for senior MOF staff. The Center is a one-stop service center for corporate taxpayers who deal with the Tax Department, the Sales Tax Department and the Customs Department. The Center, which opened in September 2003, now provides a single point for all three tax concerns. In addition, the Center provides expeditious payment of customs and clearance of goods through all points of entry. It also provides a single unified audit for both income and sales taxes, resulting in a substantial reduction of the administrative burden on the taxpayers. However, separate auditors perform this function as a team. Most importantly, the staff of the Center has been carefully trained to listen to taxpayer's problems and work out practical solutions satisfactory to both the taxpayer and the tax departments.

This Center has received significant assistance in training and equipment from the CTA. While it is still new and experimental, it is increasingly viewed as a viable alternative to the current organization structures of the existing tax departments.

The overall results of the CTA can be characterized as "mixed". The contractor, BearingPoint, delivered what it was expected to deliver but not all of the intended project objectives were achieved. To some extent this resulted from a clash between sound tax policy advice and social policy interests beyond the control of the MOF. Other reform priorities within the GOE distracted legislators from enacting needed changes in tax policy. Bureaucratic inertia may also have played a role but the creation of the MCTC and the soon to be opened Professional Tax Center offers the opportunity to overcome this problem.

The modernization of taxation in Egypt is a "work in progress" and the CTA has provided an important foundation. Tax policy issues are now well known and understood and the MCTC represents a sea change in the way the MOF deals with taxpayers both organizationally and philosophically.

CHAPTER ONE: INTRODUCTION

The Corporate Tax Activity (CTA) is the title of the last five and a half years of USAID/Cairo's sixteen year program of assistance to reform and modernize virtually all aspects of taxation in Egypt. Initial discussions were held between USAID and the Ministry of Finance (MOF) as early as 1986, at the end of a very limited prior training activity with the Tax Department. Following the design and negotiation of the new program, a technical assistance contractor was brought on board in 1989. The first phase of the program was entitled "Public Finance Administration Project" (PFAP). The contract was awarded to KPMG Pete Marwick (later renamed Barents and currently BearingPoint). The PFAP provided $30 million in assistance and the CTA added $31 million bringing the total amount to date of $61 million.

The MOF's interest in undertaking the overall program arose from the increasingly unmanageable budget deficit brought on by the gradual collapse of the state managed economy. During the 1980's budget deficits were significantly high that and were largely financed by cuts in investment and services and by borrowing from the Central Bank of Egypt. The MOF felt that this socially unsustainable and inflationary condition was due, in part, to the absence of adequate broad-based tax instruments and the inefficiencies inherent in the labor-intensive manual administration of existing taxes.

This situation was permitted to occur because the state managed economy had not relied on broad-based taxes to finance government expenditures. Easy to impose customs duties and excise taxes on selected items were important sources of revenue. In addition, non-tax revenue sources such as the Suez Canal and royalties from oil were important. On the tax side, the personal income tax was largely raised from withholdings from state employees and the corporate tax base was mainly state owned enterprises. Among the latter group, what the government did not collect in taxes, it obtained through the remittance of corporate profits to the treasury.

For the remaining taxpayers, the main concern was to ensure that those who earned their income from "professions fees" and the newly emerging private sector (mainly joint ventures with foreign partners) were adequately taxed. Individuals and companies falling within these two categories of the base, for the most part, were visibly rich and presumed to be cheating on their payment of taxes. Due to the complexity of these taxes, serious inefficiencies in tax administration and the dearth of information and methods to verify taxpayer returns, considerable animosity arose between the taxpayers and the Tax Department. It was the treatment of these taxpayers which earned the Tax Department its reputation for arbitrary and capricious behavior in the assessment and collection of taxes, a reputation that it is now struggling to change.

In short, at the end of 1980's, Egyptian tax policy, law and administration was wholly unprepared for the transformation from a state managed import substitution economy to a private sector led, market based participant in the global economy. [1]

[1] An overview of Egypt's economy is presented in Appendix III.

The primary focus of the PFAP was the design and implementation of a new general sales tax, which was passed by the People's Assembly and implemented in 1991. In addition, the PFAP supported a number of key policy reforms in the administration of personal and corporate income tax. Finally, the project began the very large undertaking of modernizing the administration of the income tax. By 1998, substantial progress had been realized. The new sales tax had become a significant source of revenue, generating approximately 28 percent of current revenues[2]. The newly established Sales Tax Department had become well staffed, well organized and significantly automated.

In the income tax, the differential taxation of individuals by occupation was largely ended and the marginal rates were simplified and reduced to 20 percent for those whose taxable wage income was less than LE 50,000 and 32 percent for all others. On the corporate side, the tax was lowered to a flat rate of 40 percent although producers of industrial and export products were given a preferential 32 percent rate. An exception was also made for oil exploration and production companies whose rate had been established by contracts with the GOE. While important policy reforms were achieved, there was less progress in modernizing tax administration and very little progress in introducing automation.

The CTA is the follow-on activity to the PFAP and began in September 1999. It was designed to provide further support to the policy reform effort, particularly in income tax. It was also to support the extension of the sales tax to the wholesale and retail sectors and to several service sector activities that had not been included in the original sales tax law. The CTA contained significant resources to improve the management and staff of the two tax departments and to make significant progress in automation, particularly in terms of Management Information System (MIS) capabilities. The extent, to which the objectives of the CTA were accomplished, is the concern of this evaluation.[3]

PURPOSE OF THE EVALUATION

The evaluation scope of work states the following:

> The purpose of the evaluation is to perform an end-of activity assessment to determine the extent to which goals and objectives were relevant and achieved in implementing the [CTA] activity and to inform USAID of the evaluation's findings, conclusions and recommendations so that USAID can use these lessons learned when designing any future and/or similar activity.

METHODOLOGY OF THE EVALUATION

The evaluation was conducted in June 2004 by a three-person team consisting of two senior economists and an economist. Prior to arrival in Cairo, the team reviewed various reports prepared by BearingPoint and interviewed the Senior Vice President of BearingPoint responsible for this project.

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[2] See Appendix II. Table (1)

[3] For a detailed description of the policy issues see "A comprehensive Tax Reform Program for Egypt", and "A Comprehensive Program for Tax Administration Reform in Egypt", submitted to the Ministry of Finance, Government of Egypt and USAID, Barents Group LLC, June 2000.

During the three weeks of field work in Cairo, the team held in-depth interviews with senior officials at the Ministry of Finance, the on-site contractor staff and USAID project management. Three separate round-table discussions were held with representatives of twenty corporations registered with the tax authority. In addition, the team made site visits to the Sales Tax Training Center, the Income Tax Training Center and the new Model Customs and Tax Center. Additional documentation and reports available in Cairo were also reviewed.

The following four chapters of this report present our findings. The presentation of each component of the project begins with a quotation from the contractor's scope of work stating the results expected from the assistance provided through the life of the contract. This is followed by a discussion of the assistance delivered including any problems encountered. Finally each section ends with the evaluation team's conclusions.

Chapter Six draws important conclusions from the finding and Chapter Seven presents the evaluation team's recommendations.

CHAPTER TWO: TAX DEPARTMENT COMPONENT

This chapter focuses on the objectives and results of the CTA's assistance activities directed at the Income Tax Department.[4]

The Income Tax Department received assistance under the PFAP, which resulted in an improved income tax law and some improvement in the processes and administration within the Department. A relatively greater effort was made under the CTA. Nevertheless, the Tax Department's processes remain largely manual and employ administrative practices that some taxpayers claim have been unchanged since the creation of the Department in 1939.

Income tax policy as embodied in Law 157 of 1981 (before being amended in 1993) imposed a complex and burdensome structure with serious inequities, incentives for inefficient economic behavior and few penalties for tax avoidance. For example, in keeping with the socialist nature of the economy, wage income was given preferential treatment compared to income earned in the "professions". There were high marginal tax rates on business income and a wide variety of industries and circumstances that were granted tax exemptions or "tax holidays". Interest on bank deposits were also tax exempt while borrowers could take a deduction for interest paid, thus encouraging debt rather than equity finance of investment. The law contained numerous other lesser violations of the basic principles of taxation.

With assistance provided under the earlier PFAP, the tax law was amended in 1993 to significantly reduce the differential treatment of income by source and to lower tax rates. This represented an important movement towards a global income tax and a flattening of marginal rates. However, many deficiencies remained in the law by the time the CTA was begun.

Task 1: Policy Initiatives[5]

Expected Result:

- Recommend new policy initiatives for the tax laws and legislation in order to create a coherent and comprehensive tax system that encompasses both Corporate and Personal Income Tax in light of the developments in the Egyptian economic environment as well as the policy changes suggested by the contractor.

[4] The Tax Department is responsible for administering the personal and corporate income tax. It is the largest tax authority in the Ministry with 48,000 employees, 16 regional offices and 226 district offices. Its responsibilities put it in direct contact with every taxpayer in the country and it is the bureaucracy that most taxpayers think of first when the word "tax" is mentioned.

[5] This section discusses tax policies associated with the base, rate, exemptions and penalties. Policies associated with the method of levying the tax are discussed in other sections of this report such as Reorganization, Audit and Collections.

Findings:

1. In accordance with its scope of work, BearingPoint prepared and submitted a comprehensive tax reform proposal to the MOF in June 2000. The portion of the proposal dealing with income tax (both individual and corporate) reviewed all aspects of the prevailing tax policy and identified the remaining areas where reform was needed. The proposal provided a clear explanation of each of the problems and went on to recommend corrective measures. In short, the proposal entitled "A Comprehensive Tax Reform Program for Egypt" was an excellent piece of work.

2. For approximately six months following the submission of the proposal, BearingPoint held policy discussions and presentations with the MOF including a two-day workshop. In the first quarter of 2001, the MOF issued a White Paper on tax reform to be used as the basis of review and discussion with various businessmen's associations in Egypt. The White Paper contained a number of the reforms recommended by BearingPoint particularly related to further implementing the Global Income Tax and reducing rates. However, other aspects such as the inclusion of bank account interest in the tax base, the removal or reduction of exemptions and the stiffening of penalties for tax avoidance were omitted. An analysis of the White Paper by BearingPoint noted that while the White Paper reflected reform progress, it would have little impact on expanding the taxpayer base and would, if adopted, result in reduced revenue.[6]

3. Further discussions of the White Paper were held between the MOF and BearingPoint and some progress was made to include BearingPoint's recommendations regarding increasing penalties and interest on delinquent taxes. By early 2002 a draft law was submitted to the Ministry of Justice for its review and to the Cabinet for its approval. The MOF's target date for Cabinet approval and submission to the Peoples' Assembly was November 2002 and leading up to this date BearingPoint supported the MOF in preparing related technical papers and responding to issues raised. However, while the Ministry of Justice and Cabinet approval was obtained, the Peoples' Assembly informed the MOF that their calendar was too full to consider the bill in the session beginning in November 2002. Thus, the MOF's income tax reform program was put on hold until the next year's session of the Peoples' Assembly. BearingPoint took the opportunity to prepare suggested answers to potential questions that could be raised by the members of the Peoples' Assembly.

4. Unfortunately, the Peoples' Assembly was also unwilling to schedule its deliberations on the bill in the 2003 session and no new date has been set as of the time of this evaluation.

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6 The White Paper was more than just a discussion paper on tax policy. It was a position paper essentially stating what the MOF was and was not prepared to do. In comparing the MOF's position with the BearingPoint recommendations, one sees the clash between a tax structure ground in sound economic principles and certain social and political attitudes which take precedence, a problem not unique to Egypt. The White Paper, by its omissions, identified a number of "brick wall" issues, that is, issues that the MOF was reluctant to raise because it felt they were not politically acceptable. These include the taxation of interest earned on bank deposits, tax holidays and exemptions, the system of additions and deductions, and its initial unwillingness to impose stiffer penalties on tax evaders.

Consequently, while the groundwork for the new income tax law has been done, no reform has actually been adopted into law since the last revision of the tax law in 1993.[7]

Conclusions:

In terms of the expected results as stated above, the evaluation team feels that BearingPoint fully achieved the stated expected result during the project period. The issues of importance to further reforming the income tax law have been laid out for the MOF and appropriate reforms have been proposed and supported by sound economic rationales. The fact that not all of the proposals were accepted by the Ministry of Finance and the Cabinet and no action has been taken by the Peoples' Assembly reflects factors outside the purview of the technical assistance contractor.

Task 2: Computerization Initiatives

Expected Result:

- Continue the computerization initiatives begun under the Public Finance Administration Project.

Findings:

1. The sine quo non of a modern tax department is the full automation of its processes and reporting. At the time of this evaluation, the head of the ADP Department roughly estimated that the Tax Department had about 50 percent of its hardware needs, less than 50 percent in terms of software development for MIS purposes, and virtually no automation of processes such as the audit function.[8]

2. Work in this area began at the start of the project with an analysis of needs leading to a proposed procurement plan. Commensurate with this was the design of the Management Information System (MIS). While the initial procurement plan was prepared by the end of 1999, various revisions required one year of negotiation before the plan was ready for submission for USAID (IRM) approval. Following this, a year and a half was spent in trying to reach agreement among the various parties (the MOF, USAID and BearingPoint) on the technical specifications and questions related to site placement, configuration quantities and installation and support services. In addition, some time was required to finalize the financing arrangements associated with the procurement. Procurement was finally begun in mid-2002.

[7] It is not entirely clear to the evaluation team as to why the proposed legislation is on hold. The evaluation team was told that the Peoples' Assembly had determined that other pending legislation had a higher priority and urgency. Other interlocutors felt that the reluctance to consider the legislation arises from the likely reduction in revenue which will result at a time when the GOE is facing serious budget deficit problems. Still others felt there may be some resistance to the bill's increases in penalties and interest on delinquent taxpayers or resistance to the reforms in the treatment of paid-in capital and imputed rent.

[8] It is not the purpose of this evaluation to review the amount and appropriateness of the hardware and software provided by the CTA. This information is better reported by AID's Office of Information Resource Management (IRM). An IRM expert conducted a review of this procurement simultaneously with this evaluation. Refer back to Corporate Tax Project - M/IRM Technical Close Out Review - Cairo/Egypt – June 20-24, 2004.

3. A project report mentioned that part of the reason for the difficulty in finalizing the procurement was the absence of a long-term plan within the Tax Department, which, in part, relates to the lack of clarity on future developments in tax policy and organizational reform. Anecdotal evidence suggests that there also may have been a difference of opinion among the parties over the issue of "state of the art" versus "essential needs".

4. With procurement underway, attention was turned to establishing high speed connections with the Tax Department's field offices, the development of software for case tracking and the modification of the Income Tax Administrative Computer System (ITACS) to provide web-enabled tax filing. As of the time of this evaluation, 195 of the 266 district offices are connected with the Tax Department by high-speed telecommunications links.

Conclusions:

The CTA has made important progress in computerization of the Tax Department. However, much remains to be done. Sufficient automation is now in place for the preparation of basic real time (almost) and scheduled reports for management needs. But, because not all district offices are linked, some portion of the data is not yet real time. Because of this, some senior Tax Department officials said they did not yet have full confidence in the accuracy of the reports.

Moreover, the evaluation team sensed that managers have not yet had sufficient experience with computer generated reports to become fully comfortable in accepting their findings. Thus, a corporate culture that bases its management decisions on appropriate MIS reports has not yet developed in the Tax Department.

Task 3: Tax Collections

Expected Results:

♦ Recommend and implement a complete tax monitoring system in order to enhance the tax collections process.

Findings:

1. The Expected Result would suggest that the project's assistance efforts in collections were to focus on the development of an MIS that produces appropriate reports to inform management. However, BearingPoint went beyond this somewhat narrow objective by providing training in modern collection methods and assisting the Collections Department in a pilot effort to improve the collection of arrears. The difficulties encountered in trying to implement this pilot collection effort provides stark evidence of the extent of administrative reform needed in the Collections Department.

2. The pilot activity was to introduce a taxpayer notification process in which letters would be sent to inform the taxpayer of delinquent payments. The originally design of the pilot called for a stratified sample of 400 taxpayers in each of five district tax offices. However, this was later reduced to three district offices. Model letters of notification were prepared and the amount of delinquent payment owed was identified from each taxpayer's file. In late 2000, the letters were sent out to the taxpayers.

3. The first problem encountered was that while the letters themselves had been prepared on a word processor, the envelopes had been hand addressed. A full 60 percent of the letters were misaddressed and, therefore, did not reach the intended taxpayer. The second problem was that approximately one third of the letters that did reach the taxpayer contained substantially erroneous information on the exact liability of the taxpayer. This had resulted from the manual collection of the data from each of the files. The third problem was that when the taxpayer appeared at the tax office to discuss the letter, there was no procedure in place for the collectors to obtain partial payment or negotiate a monthly installment payment plan.

4. A senior Income Tax Department official informed the evaluation team that this pilot was an instructive flop. While he appreciated the help from BearingPoint, the weaknesses in the department overwhelmed the chance of success. He felt that this kind of effort required substantial prior work to more fully computerize the returns of each taxpayer. This has not yet happened and they must still rely on inaccurate manual methods in most processes.

5. Several senior Tax Department officials express strong appreciation for the training in modern tax collection methods carried out by BearingPoint. The Tax Training Center has, in fact, translated and reformed the material provided in one of the courses into an in-service course which it now gives at the district offices. They have learned new methods of sequestration of property and now have installment payment plans for delinquent taxpayers.

6. With respect to the MIS, the Collections Department has been provided with sample reports that management should have on a real time or scheduled basis. An unspecified number of these reports are now being generated but there are still some district offices that are not linked to the WAN network. The evaluation team was told that these un-linked offices do have computers and enter the data as they receive tax returns. CD's are then forwarded to the central office and the data is entered into the master file. However, we were told by other officials that this was not exactly the case and data was still coming from some district offices to be entered at the central office. Thus, a number of reports are not yet comprehensive or timely.

7. BearingPoint was also asked by the Collections Department to assist them in improving the "additions and deductions" system, which is a sales transaction based income tax withholding system. BearingPoint offered some suggestions on unifying the withholding rates but suggested the system should be replaced by a quarterly estimated tax payment system. However, there has been little additional assistance on this request under the CTA because the MOF is not prepared to replace the system with the estimated quarterly payment system.

8. The Collections Department, along with the Audit Department, has now decided to focus its attention on the opening of a new, experimental facility for taxpayers in the "professions". This facility is patterned after the Model Customs and Tax Center which caters to corporate returns. The new "professional" center is expected to open in September 2004.

Conclusions:

The CTA has made progress on the development of the MIS for collections information, but it is not clear that the reports are considered sufficiently complete or timely for management to rely on them for decision making. Nevertheless, there is a strong desire in the Collections Department to speed up the automation of data entry and automation of procedures and there is a high expectation that a trusted MIS will be valuable for improving the performance of the Department.

Task 4: Audit Selection System

Expected Results:

- Develop methods for improving [the] quality of audits of corporate income tax returns.
- Design, recommend and implement a complete selective auditing system for tax returns instead of the currently adopted system of 100 percent auditing.

Findings (First Expected Result):

1. With regard to improving the quality of audits, BearingPoint provided the MOF with a variety of proposals to improve the function in terms of audit quality and efficiency in management. On the basis of a review of procedures, organizational structures and auditor qualifications carried out at the start of the project, ideas regarding an improved MIS, quality controls, team audits for large cases and other organizational and management issues were presented to the MOF. In addition, BearingPoint pointed out the need for a greater overall training effort and the introduction of specialized training courses. BearingPoint also urged the Ministry to adjust its then prevailing payroll incentive system from the number of audits completed to quality measures of audits. Given the incentive to audit as many taxpayer files as possible in a given period, improving the skills of auditors would not be likely to have much of an effect on the quality of audits.

2. The project's first training effort to improve basic audit skills was reported by Tax Department officials to be initially less than fully successful. The opinion expressed was that the trainers had underestimated the degree of knowledge of the trainees and the course content and material was considered too elementary. Discussions were held with BearingPoint and a new, more advanced course was prepared for 30 auditors who would then become trainers themselves within the Tax Department. The feedback from the Tax Department on this second effort was quite positive.

3. Complementing the classroom training activity, BearingPoint assisted the Tax Training Center to develop a self-study course for new auditors. The project provided a consultant on the design of the materials and later printed the 500 copies needed of this 14-volume self-study manual. This training instrument is well regarded in the Tax Department because the Tax Training Center has neither the resources nor the facilities to adequately train new auditors using traditional classroom methods. With the self-study course, new auditors learn the material at their locations assisted by an experienced auditor/mentor.

4. In our conversations with Tax Department officials, it is clear that the most well received training were the courses and technical papers presented on specialized audit topics and methods. The subjects included audit techniques for particular industries and services such as banking, tourism and petroleum as well as special topics such as transfer pricing issues and techniques for auditing firm who maintain computerized accounts (although at this time the auditors themselves do not yet have computers and will not get them under the CTA). This type of training is typically hard to find in Egypt and the Tax Department sees it as one of the essential benefits of outside experts provided through foreign assistance.

5. A number of initial suggestions made by BearingPoint did not seem to be developed as anticipated. Specifically, the effort to implement an overall improvement in the management of the function through the use of large case audit teams and new quality control units became bogged down when the working groups were distracted from the tasks by the press of their regular duties. In addition, it is not clear from the documents provided to the evaluation team or from conversations with the Income Tax Department official how much progress has been made in developing the MIS. Views seem to vary depending on the particular reports needed by the particular manager. However, the consensus is that the reports are better than they use to be and the expectation is that they will continue to improve as the Tax Department expands its Automated Data Processing (ADP) system. The present estimate is that the Tax Department is approximately 50 percent automated.

6. The proposal to form large case audit teams was not entirely lost. Rather, a new idea for a consolidated tax office was suggested by the Commissioner of Sales Tax after returning from a project financed tour of various European tax services centers. This idea, which has emerged as the Model Customs and Tax Center (described and discussed later in this evaluation report) provides for a team approach to auditing and focuses on the relatively large firms. Thus, the large case audit team concept as proposed by BearingPoint is, in fact, being tried, but in the much broader context of a full service tax center that addresses the sales tax and customs duties obligations of the firms served by the Center.

7. In addition, the Audit Department will be testing new approaches and procedures in the soon-to-be-opened center for taxpayers who earn their income in the “professions”.

Conclusions (First Expected Result):

The project has developed methods for improving the quality of audits of corporate tax returns but the extent to which there has been an actual improvement could not be assessed by the evaluation team during the course of this evaluation. Further, improvements in the MIS are only partial as the automation of the Tax Department is incomplete. For the foreseeable future, the continued improvement in the specialized skills of auditors will rely on the Tax Department’s ability to access outside experts. Finally, the quality and efficiency improvements associated with large case audit teams depend on the success of the experimental Model Customs and Tax Center.

Findings (Second Expected Result):

1. Regarding selective auditing, the MOF requires that 100 percent of all registered taxpayers be audited annually. Perhaps this was originally not an onerous requirement and was intended to compensate for the lack of adequate bookkeeping skills among certain taxpayers. However, the very strongly held desire to maintain this objective today reflects the Tax Department's deep belief that all taxpayers consciously and conscientiously act to avoid taxes.

2. As a practical matter, it is impossible for the Tax Department to meet this objective. Thus, the audit of most taxpayers in a given year becomes delayed to the next year or beyond. Delays can reach up to five years after which the unaudited assessment of tax liability becomes final and the Income Tax Department has no further right to audit the return for errors or unreported income. However, in its effort to audit as many taxpayer files as possible in a given year, the auditors had received incentive pay based on the number of files they complete. This incentive encouraged a more rapid and cursory audit with consequent negative effects on the quality of the audit. Without a quality audit, neither the GOE nor the taxpayer knows if the correct tax liability has been determined. From the taxpayer's point of view, tax audits are costly and disruptive to their business. In combination with other practices of the system, (in particular, the current salary incentive for maximizing revenue), the effort to audit 100 percent of the taxpayers has made the tax system subject to substantial abuse and wasteful conflict and appeals. The effort continues to fuel the significant mutual distrust and disrespect between the taxpayer and the Tax Department.

3. At the Ministry level there is recognition that selective auditing has to be introduced as the economy becomes larger and increasingly more private sector. Consequently, early on in the CTA, the Minister of Finance approved proceeding with the analysis and modeling needed to establish selective audit procedures. Based on our interviews with Income Tax Department officials, it is clear to the evaluation team that the Tax Department then and now requires substantially more convincing than the Ministry that an acceptable selective audit approach can be developed and successfully implemented.[9] Hopefully, a successfully tested risk probability model will provide the convincing needed.

4. BearingPoint constructed a risk probability model from a sample of 100 construction firms whose files had been audited as part of the effort to develop the model needed by the Economic Research Department to estimate the revenue effects of various tax reforms. BearingPoint then used the model to rank a sample of 450 construction firms that had filed returns in 2003. At the time of this evaluation, audits of the top (higher risk) 60 companies and the bottom (lower risk) 40 companies are underway.

[9] The requirement for a successful selective audit system is that the Tax Department be able to identify the relative risk that a particular return is inaccurate. Then only those returns that are predicted to be of high risk are audited. To do this, a probability model is first constructed from a sample of existing taxpayer files. New returns are then analyzed within the model and the probability of evasion is determined. However, before the model can be used for the actual selection of audits, it must be verified, and perhaps adjusted, on the basis of a 100 percent audit of a new sample of tax returns.

Conclusion (Second Expected Result):

Since the testing of the risk assessment model is not complete and the statistical significance of its estimates are not yet know, the project has not yet delivered to the Income Tax Department a sound methodology upon which to base a selective audit system. Obviously, none has yet been implemented. The effort to develop and implement a selective audit system has been stymied by shortcomings in the tax files and by the other responsibilities of the auditors assisting BearingPoint which distracted them from this task.

Task 5: Public Awareness Campaign

Expected Results:

- ♦ Design, recommend and assist the Ministry of Finance and the tax departments in implementing a public awareness campaign designated to inform the public of changes in tax laws, policies and procedures.

Findings:

1. The Taxpayer Services and Awareness Department in the Tax Department was organized as a result of project recommendations and BearingPoint has worked closely with senior management to get the Department operational. There had been no such department in the past and taxpayer information was not well organized or consistent.

2. The Department is quite new as of the time of this evaluation and consists of 12 employees. Nevertheless, it has been quite active in developing and producing taxpayer brochures on tax laws and a tax awareness advertisement that was shown on local Egyptian TV channels this past December. The ad sought to raise peoples' consciousness as the tax filing date approached. The ad showed the linkages between the payment of taxes and the provision of facilities and services by the government from taxes. The Department has expansion plans to place staff at district offices. The current staff has been trained in the tax rules and in how to deal with the public.

Conclusions:

The CTA has generated a whole new undertaking for the Tax Department both organizationally and in terms of how they related to the taxpayers in the past. In conversations with senior Tax Department officials, there appears to be the seed of the notion that the taxpayer is the customer of the Tax Department, not its enemy.

Task 6: Reorganization Plan

Expected Results:

- ♦ Develop, recommend and implement a complete reorganization plan for the tax department taking into consideration the current geographical distribution of tax offices that are scattered among Egypt's 26 governorates.

Findings:

1. The comprehensive tax reform plan submitted by BearingPoint in 2000 contained a volume entitled "A Comprehensive Program for Tax Administration Reform in Egypt". This volume focused primarily on the Income Tax Department although it also contained sections on expanding the sales tax and recommendations related to the concept of the Model Customs and Tax Center being developed by the MOF.[10]

2. For each Central Department the report detailed inefficiencies, duplications and the absence of basic management information. It then outlined a comprehensive reorganization plan for the structure as a whole, for each Central Department and for the management information systems that need to be installed. Among other changes, the reform proposed a new organization chart to streamline management (currently over 270 managers' report directly to the Tax Commissioner), reallocate auditor workloads on the basis of size of company and a selective audit system, and strengthen the use of MIS.

3. The report points out that the fundamental principles that underlie income taxation in Egypt foster the organizational problems that were identified. So too does the salary incentive structure and the absence of adequate penalties and enforcement. Consequently, the system is a process of negotiation between the Tax Department and the taxpayer with the final outcome not necessarily related to the actual tax liability imposed by the law. The principle of income taxation in Egypt provides no real room for taxpayer self-assessment as the Tax Department "assesses" the tax. This leads taxpayers to understate their incomes, if they even file a return, because they know the Tax Department will assess at a higher level. Given the absence of meaningful penalties, it is estimated that 90 percent of the taxpayers appeal and less than one percent get criminally prosecuted. Thus, the appeal process is where the actual tax is negotiated. In its need for revenue, the MOF has stressed quantity over quality; quantity in the assessment and quantity in the audit process. There is no doubt that the system lends itself to abuse and there is no doubt that the system does not maximize the collection of the tax liability legitimate under the law. The evaluation team was told that arrears are now approximately LE 28 billion, only 25 percent of the taxpayers submit a return and five out of seven taxpayers submit returns showing financial losses during the year.

Conclusions:

There has been no real movement on the proposed reorganization. The reorganization plan proposed by BearingPoint requires that the basic principle of taxation shift toward a self-assessment process with tax law and administration providing the "incentive" to the taxpayer to be more honest. In addition, it requires that the tax department become fully professional in its use of management information and change its incentives to employees to focus on the quality of their work. For the reorganization to be effective as opposed to being just a reshuffling of the

[10] Without fear of exaggeration, the description and analysis of the organization and operation of the Tax Department suggests a bureaucracy so flawed and misdirected in its purpose and so "old fashion" in its methods that one could easily conclude that there was no "reorganization" solution that could remake the organization into a modern tax department.

deck chairs, a number of changes in the tax law and regulation needed to be done. Unfortunately, this has not yet happened.

BearingPoint's proposed income tax reform proposal stated "The recommendations proposed in this program, both the structure of the global income tax and the administrative changes to implement it, have been specifically designed to accommodate the economic and administrative circumstances prevailing in Egypt today,…"[11] This may have suggested to some senior MOF officials that the administrative reform was, to some degree, dependent of passage of the policy reforms. BearingPoint asserts that it never agreed with this linkage, arguing that policy and administrative reform needed to be simultaneous. Nevertheless, the MOF chose to proceed first on policy, whether due to work load or other interests such as the emerging concept of the Model Customs and Tax Center, mindful that the policy reform legislation was expected to pass in the near future.

The evaluation team does not conclude that nothing was done in the area of reorganization. Instead, we found that while only a few changes were introduced in the existing Tax Department (e.g., taxpayer services and awareness); the MOF was deeply involved in developing the Model Customs and Tax Center. It may well be that the MOF reached the same conclusion as we that a reorganization of the Tax Department was not the appropriate approach to creating a modern tax authority. Rather, an entirely new organizational concept was needed, which exactly describes the Model Customs and Tax Center.

Task 7: Anti-Evasion Tax System

Expected Results:

- Design, recommend and implement a complete anti-evasion tax system.

Findings:

1. As in the other functional areas of the Tax Department, BearingPoint initiated its involvement by conducting a comprehensive assessment of the Anti-Evasion Department and its links with other departments within the MOF. As a result, a number of procedural and legislative changes were proposed. Of the various recommendations, the Department agreed to focus its attention on large cases and to expand its efforts to identify unreported income. The remaining recommendations, including those that required new or amended laws were accepted for further consideration by the Tax Department and MOF. These are still pending as of this evaluation.

2. BearingPoint then focused on the development of a handbook for auditors and collectors to help them identify possible cases that should be referred to the Anti-Evasion Department for further investigation and perhaps prosecution. Entitled "Evasion Referral Handbook", the manual was completed in mid-2001, reproduced in 500 copies and introduced to the audit and collections staffs through a training course. BearingPoint had prepared the training course by conducting two workshops to train those who would ultimately present the course to the district office personnel.

[11] See Appendix IV-2

3. The guiding principle behind the reform recommendations and the "Evasion Referral Handbook" was to increase the quantity and improve the quality of suspected evasion referrals. However, the Anti-Evasion Department informed the evaluation team that it generally had a caseload of 3,000 files, which fully occupied the staff.

4. It would seem that the Tax Department and perhaps the MOF is somewhat averse to moving a case to increasing levels of punitive action including prosecution. With underestimation of income widely reported, most cases are settled before referral to the Anti-Evasion Department. Of the 3,000 plus that are referred, 90 percent are settled before further referral to the prosecutor's office and 90 percent of the those taken up by the prosecutor are settled before trial. In combination with the MOF's policy White Paper originally omitting increases in penalties and interest, it would seem that the ethos of the tax authority is to negotiate a settlement between the Tax Department and the taxpayer. The head of the Anti-Evasion Department said that his department does not take on cases for the money associated with the penalties but rather for its deterrent effect. We were also informed by BearingPoint that the head of the Anti-Evasion Department was now focusing more on larger and higher quality cases.

5. BearingPoint conducted a variety of training courses including topics such as money laundering, e-commerce and evasion cases involving international transactions. These courses were held in high regard and were video taped for repeat presentations.

6. The Department was provided with a "stand-alone" computer system to ensure confidentiality of the data that they collect and maintain. Specialized anti-evasion software has been promised but had not been delivered as of this evaluation.

Conclusions:

While an anti-evasion system is in place, it is largely the system that existed at the start of the project. However, the head of the Department feels that progress has been made in focusing their efforts and improving staff capabilities and evasion was reported to have been reducing over the past several years.

<u>Task 8: Data Analysis and Modeling</u>

Expected Results:

♦ Develop, recommend, gather and analyze base line and implementation data for the entire activity.

Findings:

1. The intent of this Expected Result is to modernize the capability of the Economic Research Department to analyze the revenue effects of alternative tax policies. To do this, the models used by the Department had to be updated and transferred to currently used software (they were originally written in FORTRAN). To update the models, the project had to establish a database for a more recent year (1994 was chosen).

2. In early 2000, BearingPoint proposed formats for data entry and identified a sample of 1,400 tax files. However, the Audit Department was unable to start gathering the data because of

the press of other work and the transcription began late in the year. By the end of 2000 it was realized that the sample was inadequate because an insufficient number of taxpayers had actually filed a return for the base year. A new sample methodology was then agreed to and transcription restarted.

3. The transcription process was far slower than expectations because the auditors did not want their involvement in this exercise to detract from their job of auditing returns. There was a problem with the quality of some of the transcription that had to be dealt with but also the salary incentive system interrupted the work. The incentive system paid auditors on the basis of how many files they audited in a given period and their assignment to the transcription process jeopardized this pay supplement. During the peak audit period, transcription was halted.

4. By mid-2002 the transcription was finally completed with a sample of 451 corporate returns. The Corporate Tax Model was translated from FORTRAN to Access based software and the model was made operational. Other models such as the Salary and Wage Tax Model and the Commercial and Industrial Profits Income Tax Model were subsequently also translated to Access and made operational.

5. The project has made some progress on developing a Global Personal Income Tax Model which combines the Salary and Wage Tax Model with the Commercial and Industrial Profit Income Tax Model. However, the new baseline data can not be merged due to differences in deductions between the two types of tax categories. A merger is possible when a new baseline is established.

Conclusions:

Despite considerable data and methodological problems, the CTA has established a new baseline and the relevant models have been updated. The Economic Research Department is responding to Ministry requests to assess the revenue effects of alternative tax policies. Experts in the Department feel comfortable that they know how to use the model and the related statistical software correctly. However, at this time, revisions of the models would require outside expertise. It is likely that such expertise is available in Egypt but not in the government sector because of the salary level compared to the local market for this level of econometric skill.

Task 9: Training

Expected Results:

- Develop a needs assessment and training plan.
- Continue the training initiatives of Public Finance Administration Project.

Findings:

1. BearingPoint's initial activity was to conduct a needs assessment and develop a training plan. Submitted to the MOF in early 2000, the Tax Training Department took issue with the assessment, arguing that it did not adequately describe the training facilities of the Department. Upon further investigation, BearingPoint concluded that the training centers needed major renovation and the main center in Zaitoun needed to be replaced. Thus far, the

resources provided from the MOF's own budget are inadequate to implement BearingPoint's recommendations, although the Director is hopeful that funds will be provided in the future. The project itself did provide a limited amount of equipment to the Tax Training Center.

2. In terms of curriculum, BearingPoint proposed a restructuring of the training program for newly recruited auditors. As noted elsewhere in this report, one output was the 14 volume self-study manual.

Conclusions:

BearingPoint has delivered the Expected Results noted above and its training program, both from in-house experts and through DT2, has been well appreciated by Tax Department staff and management. However, the evaluation team was not able to determine during our brief visit to Cairo if any of the more sophisticated training in audit methods have made a difference in terms of the taxpayers or the revenue collections. Senior officials at the Ministry and Department level expressed the view that training was beginning to make a difference in reshaping the attitude of the staff towards a more professional relationship with the taxpayers.

CHAPTER THREE: SALES TAX REFORM

This section evaluates performance of the Corporate Tax Activity with regard to accomplishments of tasks directed at supporting the Sales Tax Department. It assesses the extent to which each task was accomplished and what impact it had on the Sales Tax Department's performance. It also highlights the actions taken by the GOE to benefit from the technical assistance, training and commodities provided by the CTA.

In May 1991, the GOE, assisted by USAID under the PFAP, introduced a broad-based General Sales Tax (GST) Law. The GST is an invoice-credit type of value-added tax that applies to all imports, locally manufactured goods and to selected services. Implementation of the GST resulted in a significant increase in revenues from consumption taxes, from 3.4 percent of GDP in 1991 to 4.8 percent in 1992. In 2000, GST revenues represented 6.4 percent of GDP and for approximately 40.5 percent of total tax revenues[12]. Implementation of the GST was a significant achievement of the PFAP.

The CTA was implemented to consolidate the successes of the PFAP and to assist the GOE address remaining deficiencies in the GST with regard to broadening the tax base, reducing collection lags, increasing voluntary compliance, discouraging tax-evasion and improving tax administration. The GST still had numerous sales tax categories and rates, which were also addressed by the CTA.[13]

Task 1: Implementation of the Sales Tax to the Wholesale and Retail Level

Expected Results:

- Extend the sales tax to the wholesale, retail and services sectors.
- Develop policy recommendations for (a) full crediting of taxes paid on all inputs used for the production of traded goods and services, (b) reducing the number of sales tax categories and rates, and (c) eliminating or reducing the number of exemptions.
- Develop recommendations and procedures to transition the tax audit system from the traditional audit of 100 percent of taxpayers to selective audit system.
- Develop recommendations, mechanisms and procedures for paying taxes through the banking system.

[12] See Appendix II Table (1)

[13] The dispersion of sale tax rates increases tax administration costs and registrant's compliance costs. Limitations on full-crediting of taxes paid on inputs impose significant structural deficiency that could negatively impact private investment decisions. In the absence of full-crediting of taxes paid on inputs, businesses continue to absorb the cost of the non-credited GST on inputs, and administrative authorities spend significant resources distinguishing, often arbitrarily, between different types of inputs.

Findings:

1. The GST was extended to the wholesale and retail sector on July 1, 2001.

2. The GOE did not act on BearingPoint's recommendations to extend the sales tax to all services. The GST still applies only to services specified in the law[14]. Since the law was introduced in 1991 further services have been added to the list of those taxed, but none have been added over the life of the CTA, and none were added in 2001, at the time of extension of the GST to the wholesale and retail sectors.

3. BearingPoint's recommendations for special schemes and for transition issues (including stocks-on-hand) and a plan for coping with the increased workload of returns processing and payments was adopted. The plan was implemented in pilot mode in Dokki Sales Tax Center. The purpose of this pilot-test was to streamline return filing and payment procedures[15]. After a 3-month experiment, BearingPoint recommended that the procedures be approved for wider application. The recommendations included:
    - There be only 'face vet' at the time of filing,
    - Arithmetical checks be carried out subsequent to filing,
    - Payment voucher be abandoned,
    - Verification of the return take place after filing,
    - Errors and missions be dealt with after filing, and
    - Any additional tax due, interest or penalties would be calculated by the computer system when return data was inputted.

4. After studying the revenue and tax administration impact of the registration threshold BearingPoint recommended that a LE 200,000 registrant threshold be adopted. However, , the Sales Tax Department adopted a threshold of LE 150,000 for the wholesale and retail sectors but kept the threshold level of LE 54,000, introduced in 1991, for the manufacturing sector.

5. Recommendations to convert the extended sales tax system to a full Value-Added Tax (VAT) were not acted on by the GOE. The existing GST is not yet a full VAT. In a full VAT one would expect there to be full-crediting for taxes paid on inputs[16] and also that more services would be taxed. In addition, one would expect the commodities listed in Table 1 of the Law, which are subject to an excise tax only, to be subjected to the sales tax law.

6. BearingPoint's recommendations to reduce the sales tax categories and rates were not acted on by the GOE. The only amendment to the sales tax legislation was the increase in

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[14] In most countries the law brings all services into the tax and then specifically exempts those services the Government does not wish to tax.

[15] At the time of the pilot, the practice was to check carefully every return before it was 'filed' and only when the official checking the return was satisfied that errors had been corrected would the return be accepted as filed. Also the registrant was required to fill out a complicated 'payment voucher' in order to make payment. This meant registrants spent hours in line waiting to file or waiting while their return was checked. It also imposed a heavy burden on office manpower during peak filing periods.

[16] Under the existing tax law, credit is given only for inputs physically embodied in the product sold. For example, the machinery and power used in manufacturing are not embodied in the commodity which is made and so no credit is given for the purchase of them.

the sales tax rate charged on tourist transportation and services from 5 percent to 10 percent; and the clarification if the phrase ‘operating services’, which was frequently challenged in the courts. Law 11, passed in 2002, gave a more precise definition of the phrase.

7. In order to process tax returns and payments more efficiently under the extended sales tax, the CTA recommended the use of the banking system and post office for tax payments and filing. The CTA also developed a new and simplified tax return that reduces the reporting requirements on registrants. A process for making sales tax payments through the banking system was developed and discussed with the National Bank of Egypt using various methods for taxpayers to make their payments including: debit card, credit card, electronic funds transfer, check and cash, as well as setting up card machines at each district office for the taxpayers’ convenience in making their sales tax payments using a bankcard. Payment through the banking system was pilot tested for 6 month in 2001 with cooperation from the National Bank of Egypt. However, delays in processing checks and transferring funds to the Sales Tax Department account, the National Bank of Egypt’s wish for a monopoly on the service and the demand by the bank for a higher fee meant that the Sales Tax Department and the bank could not reach a commercial agreement on extending the pilot. However, since that time the SWIFT clearing system has been introduced, which has significantly cut the time it takes to get funds transfers. With the Central Bank of Egypt’s assistance, the cooperation of all banks to participate in a system of bank payment was achieved in mid-2003. Since then the procedures, computer programs, etc., have been developed and tested so that the SWIFT can be used instead of direct payments at the Sales Tax Department offices. The use of banks for paying sales tax will be introduced nationwide for all registrants wishing to use it from July 1, 2004.

8. The feasibility of introducing the compulsory use of cash registers by wholesale and retail businesses was investigated and a report was presented to the Sales Tax Department. However, the GOE has not acted on this concept.

9. In terms of sales tax revenues, there has been a considerable increase. For example, in year 1990/91, tax revenues were only LE 4 billion. However, with the introduction and extension of the GST to the wholesale and retail sectors, tax revenues increased significantly reaching LE 23 billion in 2003[17].

10. In terms of tax compliance, according to the Commissioner, the industrial and the service sectors exhibit 96 percent compliance. On the other hand, the trade sector exhibits 84 percent compliance. The Commissioner also noted that every year there has been a steady increase in the levels of tax compliance[18].

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[17] See Appendix II Table (1)

[18] It should be noted that the Sales Tax Department has made significant strides in developing taxpayer services and awareness. Much of this was achieved during the extension of the GST to the wholesale and retail sector. It developed extensive outreach through the establishment of effective Media and Information department and publications for the general awareness and specific taxpayer use. Relationships have evolved through frequent contact with Chambers of Commerce and professional associations, as well as the press. It has also established a Public Opining Unit in order to obtain more feedback. Recently it conducted a customer satisfaction survey.

Conclusions:

- A significant achievement of the CTA is the extension of the GST to cover the wholesale and retail sectors, which has increased tax revenues substantially. For example, between 2002 and 2003 it jumped by 12 percent to approximately LE 23 Billion[19].

- At this point, it appears that the GOE will not transition the GST to a full Value-Added Tax for social and political considerations.

Extension of the GST to the wholesale and retail sector has resulted in a significant increase in the number of businesses registered and a corresponding requirement to improve tax administration. In order to enhance the efficiency and effectiveness of the sales tax system, the CTA provided extensive support in the use of information technology, reorganization and streamlining of the various functions of the Sales Tax Department and the transfer of knowledge and skills to the staff. Our findings and conclusions are discussed below.

Task 2: Computerization Initiatives

Expected Results:

- Upgrade the General Sales Tax Administration System (GSTACS) particularly after the extension of the tax to the wholesale and retail levels
- Update the GSTACS Complimentary Systems: Tax Evasion, Collection, Audit, and Inspections
- Upgrade the Department's non-tax administrative and financial functions
- Continue linking the central office with the district offices

Findings:

1. The General Sales Tax Automated Computer System (GSTACS) was upgraded and pilot-tested and adopted in 2002. Currently, BearingPoint is working on the next release of GSTACS, which will incorporate new filing and payment procedures and centralized processes to issue to taxpayers (a) assessments for stop-filing, (b) penalties for late filing, and (c) immediate demand notices for non-payment. Changes to the GSTACS will also include the automatic issue of (a) registration certificates, (b) amended certificates of registration and (c) deregistration notices. To date, in addition to technical assistance, the CTA has expended or committed more than $6.6 million for computer hardware, software and computer training in support of the Sales Tax Department.

2. The development and full integration of the GSTACS Complementary Sub-systems including Audit, Anti-Evasion, Survey, Collections, Debt Tracking, Registrant Assistance, Legal Affairs, Capital Goods and Exemptions were finalized in 2002. The Audit sub-system includes the audit reporting forms that are loaded onto laptop computers for use by auditors in the field.

[19] See Appendix II Table (1)

3. The implementation of the automatic and online transfer of data/transactions between the three levels of the Sales Tax Department organization (central, regional and district levels) has been completed. The central office of the Sales Tax Department and its 23 regional and 106 district offices are now automated and integrated.

4. According to the Sales Tax Department, to date, more than 1,100 operational staff has been trained in basic computer skills and the use of the relevant GSTACS applications. Computer specialists have also been trained to maintain and carry out future development of the system as a whole.

5. BearingPoint also submitted the outline of an automated case tracking system that builds on the functions provided by the GSTACS. The design was reviewed and accepted by the Sales Tax department staff working on enforced collection.

6. According to the Commissioner of the Sales Tax Department computerization of the auditing and anti-evasion internal processes are incomplete. According to the Commissioner this has negatively affected the workflow of the department.

7. The Sales Tax Department's non-tax administrative and financial functions have not been upgraded. However, BearingPoint has completed an assessment on the current status of these functions and has provided it to the Sales Tax Department.

Conclusions

- The CTA has successfully completed the computerization of the relevant sales tax administration functions including audit, anti-evasion, survey, collection, and debt tracking and further enhancement can be carried out by the IT personnel.

<u>Task 3: Strengthen New Departments</u>

Expected Results:

- Recommend and advise the Sales Tax Department on ways to strengthen the functions, goals of the Planning, Tax Research, and Personnel Departments, and recommend further reengineering action for the Sales Tax Department.

Findings:

1. The CTA focused on enhancing the capacity of the Survey Department, which is responsible for identifying and registering new businesses for the tax, to improve its procedures and to better utilize its database records in identifying unregistered businesses.

2. BearingPoint provided refined mission statements, roles and responsibilities of the Audit, Anti-Evasion and Survey departments. It has delivered the first draft of a Software Requirement Specification (SRS) for a case tracking system for use by the Anti-Evasion and Survey Departments. It has also provided assistance to transform the Survey

Department into an intelligence unit to ensure a more balanced and targeted approach to non-compliance.

3. In the area of tax audit, BearingPoint has provided technical assistance to both the Audit Planning and the Audit Research Departments. The range of activities has included advice on formulation of the annual audit plan; review of the audit manual; and development of industry specific technical notes to assist auditors in the field. The CTA also trained the Planning Department on its organizational roles and responsibilities, planning methodology and performance measurement.

4. BearingPoint's recommendation to abandon the systematic gathering of individual transaction details for what is termed commonly 'transaction matching' has been adopted. Currently, GST returns are accompanied by summary transaction listing which are being phased out with the new GST returns for the July–August 2004 tax filing period. As part of this new approach, the CTA has recommended and the Sales Tax Department has adopted use of a revised Sales Tax Return form that has been reduced to only 17 boxes and makes no provision for listing or attachment of transaction details.

Conclusions:

- The CTA has achieved its expected results under this task. Complete adoption of its recommendations by the GOE will require a fundamental change in the civil service law with regarding to recruitment of new graduates, geographic relocation or reassignment of the staff.

- Further change in the law is required to force auditors to rely on computerized books of accounts of taxpayers. Since currently the law requires that the taxpayer keep an original manual book of accounts, tax assessors and auditors reject computerized accounts if the original manual books of accounts are not up-to-date or maintained correctly. This means that the taxpayer has to maintain a dual system at significant transaction cost.

<u>Task 4: Registrant Assistance</u>

Expected Results:

- Develop and enhance the capacity of the registrant assistance department by:

  - Establish a special cadre of employees to better serve taxpayers
  - Establish the communications network to respond to the registrants inquiries through telephone, computers and internet
  - Prepare manuals and handbooks
  - Reorganize and computerize the registrant assistance department

Findings:

1. The CTA has provided technical assistance, training and commodities and enhanced the capacity of the Registrants Assistance Department (RAD) to develop a mass mailing campaign and a publicity brochure, directed at potential new registrants[20]. The CTA has also enhanced capacity of the RAD to conduct registrant satisfaction surveys.

2. The CTA has provided technical assistance and training to enhance capacity of the RAD to develop standardized answers to registrants' most frequently asked questions (FAQs). The CTA has also provided technical assistance for the development of a web site that can be accessed by registrants and members of the public seeking information about the sales tax and its administration.

3. The CTA has provided technical assistance and training to the Media and Information Department that is responsible for improving public information and awareness. It has also provided training on (a) the preparation and production of a TV mini-series on the concept of taxes, (b) the preparation and production of an informative documentary on the tax structure in Egypt, (c) the production of a TV and Print media advertising campaign on taxes, and (d) media relations.

4. The CTA has developed and recommended the use of a simplified Sales Tax Return form for dissemination to taxpayers[21]. The new form has only 15 boxes to be completed by the taxpayer and will be phased in the July-August 2004 sales tax return period.

5. A small sample of taxpayers, all unregistered with the Model Customs and Tax Center (MCTC), which the evaluation team interviewed, indicated that there is some confusion among taxpayers as well as among tax auditors on how the new sales tax law applies. They said that, "the tax liability determined by one tax assessor (their term) is different from the tax liability estimated by a second assessor or auditor." These taxpayers indicated that more clarification and communication of how the sales tax law is applied is needed.

Conclusions:

- The CTA has accomplished the expected results under this task. However, the RAD will need to do a better job in communicating to taxpayers how the new tax law applies. The Sales Tax Department will also need to train tax assessors and tax auditors on common format for validating the tax liability submitted by tax payers.

- The confusion about how the new sales tax is applied seems to be related partly to the culture of 'negotiated' tax settlement rather than anomalies in the law.

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[20] The publicity campaign included regular press releases, press conferences, TV interviews and public service broadcasts. A telephone "hot-line" was established to enable the public to report retailers who, in contravention of the legal requirement to do so, refuse to issue a tax invoice.

[21] Up till now the Sales Tax Department conducted a systematic gathering of individual transaction details for what is commonly termed 'transaction matching'. All GST returns were accompanied by summary transaction listing. Under the new approach there are no provisions for any listing or attachment of transaction details.

Task 5: Organizational Structure

Expected Results:

- Redesign the organizational structure to accommodate the expanded responsibilities of the Department after the extension of the tax to the wholesale and retail levels
- Revaluate the current geographic distribution of the tax offices in light of the tax expansion and design different action plans for reorganizing the department

Findings:

1. In 2000, BearingPoint had developed a comprehensive structural reorganization and resources development plan and recommendations for restructuring headquarters, regional offices, and district offices and on performance evaluation, incentive schemes, and the selection for promotion to management. It also had developed baseline-staffing estimates for all District Offices, Regional Offices and Headquarters. The plan had also recommended redeploying staff out of the head office to district offices, which deal directly with the taxpayer, and also from non-functional areas to functional ones. In addition, it had recommended complete reorganization along the lines of the key tax functions including audit, collection, taxpayer assistance, survey (i.e., identification of non-registered businesses which should be registered) and anti-evasion.

2. However, few employees have been redeployed from the central office to regional or district offices. Headquarters remains top-heavy so the first set of recommendations was not implemented. This may be related to the fact that the Department is obliged by the GOE to recruit a certain number of graduates and it cannot reduce the staff numbers. And under the existing civil service law, civil servants cannot be relocated without their consent to different geographical relocations or be transferred into a new functional area. Therefore, the tendency is to recruit to fill vacancies at district level rather than relocating or redistributing existing personnel to the districts.

3. The functional reorganization has been completed with the introduction of a coherently structured registrant assistance department, reorganization of survey and anti-evasion into two new ‘intelligence’ and ‘investigation’ departments, realignment of the collection function and some slight reorganization to audit.

4. In 2002, the CTA implemented a performance measurement system[22]. In 2003, the CTA and Sales Tax Department counterparts took action to remove many of the overlapping areas of competence in the different departments. They revisited and refined mission statements and organizational roles and responsibilities of the Audit, Anti-Evasion and

[22] Some performance measures were introduced in the last fiscal year in the audit, anti-evasion and survey departments. Discussions on performance measures were not sufficiently advanced for all CTA recommended measures to be introduced in the fiscal year ending June 30, 2004. The objective was to monitor and report areas of significant revenue yield and significant cases of tax evasion.

Survey Departments. They also transformed the Survey Department into a more cohesive intelligence department (with increased emphasis on revenue leakage and identifying fraud). The Anti-Evasion Department was re-oriented to focus solely on the investigation of significant or large-scale sales tax evasion.

Conclusions:

The Sales Tax Department reorganization recommendations have been adopted as much as the civil service law can allow. Further reorganization and departmental realignment along the BearingPoint suggested workflow system will have to be managed by broadening and deepening the use of computerized information management systems.

Task 6: Training

Expected Results:

- Prepare training needs assessment
- Design, recommend and develop an efficient administration for the Tax Training Center in Maadi with respect to training programs, courses, curricula, and research facilities
- Link the Training center with regional training centers in the governorates
- Design, recommend and develop the training process in terms of computerization, video conferences, and training-of-trainers

Findings:

1. The Sales Tax Training Center was officially opened in September 1999. According to the director of the training center, the training center's mission is to (a) train the sales tax department employees to better serve the public[23], and (b) raise awareness of the public about changes to the tax law through information campaigns, conferences, and meetings between the specialists from the tax departments and the stakeholders to discuss the new

[23] All sales tax department employees have to take a series of courses at the training center in order to qualify for promotion (Law 47). Training "Credit Days System" (CDS) divided into: 70, 100, and 30 days, respectively is used to qualify the employees for promotion. The employee cannot move to the second stage before passing the exam of the previous stage. The sales tax department employees are offered (a) specialized technical training, (b) administrative / management training, (c) computer software training, and (d) English language training.

New recruits undergo through several stages of training before they are assigned in their specific competencies. First, a recruit undergoes a behavioral test to discover his/her personality characteristics. Then he/she takes 3 months of training on the various functional areas of the sales tax department. Based on evaluation of the training center the recruit is channeled to specific job within the tax department. Second, the recruit undergoes a month and half on-the job training. This is done to ensure that the recruit is using all the communication skills he/she has been taught. Then the recruit takes a written test in the training center and is evaluated by his/her supervisor. Finally, the recruit is channeled to a suitable job. Third, after assignment to a permanent job, the employee is given a specialized training according to the needs of his job.

sales tax law. And according to the director more than 26,000 and 15,000 employees were trained in 2002 and 2003, respectively.

2. The CTA provided extensive support to transform the training department into a modern and useful training center. It undertook a number of initiatives. Before embarking on course development and training, BearingPoint along with its Sales Tax Department counterparts conducted a comprehensive training needs assessment using a 'systems approach'. The BearingPoint's 'Front End Analysis' approach to training needs assessment expanded the scope and coverage of training to a number of important areas including: training practices, training delivery systems, organization and staffing, and staff location. Cadres of course developers from all major functional areas were trained.

3. The existing employee remuneration and incentive scheme has negatively influenced the quality of the training programs. Three major areas are adversely affected: Instruction, Course Design and Development and On-The-Job Training. Under the existing incentive system, the best strategy for anyone assigned as an instructor or course developer is to try to accomplish his/her monthly quotas at his/her regular job as well as concurrently meet his/her assigned training responsibilities. Individuals engaged in a training activity were often forced to stretch their energies between their regular jobs and training related tasks.

4. On-job-training (OJT) is administered informally in some location by some managers. There was no structured program in any function to systematically provide planned OJT, and coaches had not been trained on how to conduct OJT.

5. The CTA recommendation for the establishment of Standards and Quality Branch was adopted to address problems in the quality of instructional material. This organization is responsible for establishing a standard template to be used by all departments when designing and developing courses. A template provides a style guide of how materials should look and what should be included in all materials. This standard template covers: Instructor Guides, Participant Guides, Exercises, Tests, and Audio/Visual materials. In addition, train-the-trainer courses were developed for (a) course design and development, (b) using audio/visual equipment, and (c) course delivery. The CTA also assisted in the development of an Annual Course Development Training Plan to assist in course development to respond to skill gaps. It also assisted with the establishment of a Large Trader Audit Training Unit.

6. A few senior officials mentioned that, some courses delivered by BearingPoint were not effective. They lacked depth and were not directly applicable. Sometimes, experts were assigned to deliver training in areas where they did not have in-depth knowledge or expertise. This resulted in the trainees feeling the training courses were just a waste of their time.

Conclusions:

- Although, the CTA has provided assistance to the Sales Tax Department Training Center and provided training on various subject, additional training is required to impart latest international experience and practices on various aspects of tax administration. For example, specialized courses such as money laundering have transferred valuable skills to the staff. However, it is important to ensure that these skills are widely available by selecting and training trainers.

- For training to be applied effectively on the job, the existing tax officers' remuneration and incentive schemes need to be adjusted. In addition, training should be linked to the career path of tax officers. The existing remuneration and incentive schemes seem to encourage a practice generally referred to as "tax farming" and to poor quality audit of taxpayers. The professional staff is rewarded on the basis of meeting or exceeding targets set for the number of cases handled and the amount of tax revenue generated and on the basis of seniority rather than on performance.

- Training Credit Days used by the Sales Tax Department as a condition for promotion is still tied to the seniority system instead of job performance. What is needed is a merit-based system regardless of when the individual entered into service. On-the-job performance and competency improvements to a targeted skill level would form better conditions for promotions.

Task 7: Economic Research Department (ERD)

Expected Results:

- Upgrade and institutionalize the ERD
- Assist the ERD with revenue forecasts

Findings:

1. The CTA has imparted analytical and report writing skills to the staff of the Economic Research Department. To enhance skills of the ERD staff the CTA developed a study of the impact of a change in customs tariffs on 55 commodities. This exercise was used to enhance the analytical capabilities of the ERD staff. Economic analysis tools were used to develop an effective understating of tax collection problems.

2. In addition to developing simulation modules for use by the staff of the ERD, the CTA has provided and installed seven copies of Eviews[24] statistical software package. However, it is not evident if the staff of ERD is able to use Eviews for revenue forecasting.

3. The CTA also assisted the creation of a six-member 'Information Analysis Unit' (IAU) within the larger ERD framework. The main function of the IAU is to provide the Commissioner executive summaries of the monthly reports and data produced by the different sections of the Sales Tax Department.

Conclusions:

- The Economic Research Department staff is capable of conducting revenue forecast and analysis of impact of policy change using the CTA provided simulation and

[24] Eviews is a software package used for revenue estimation and forecasting. It combines spreadsheets and relational database technology. It is used for general statistical analysis, time series estimation and forecasting, cross-section or panel data analysis, large scale model simulation and simple data management.

forecasting models. However, the staff is not yet able to develop and program its own simulation and revenue forecasting analytical constructs.

CHAPTER FOUR: MODEL CUSTOMS AND TAX CENTER

The Ministry of Finance created the experimental Model Customs and Tax Center (MCTC) to administer all taxes and duties as they apply to large taxpayers. This concept was not envisioned at the time the CTA was designed nor was it included in Bearing Point's Scope of Work. However, because it provides an innovative solution to a number of serious tax administration problems, CTA resources were directed to assist in its development and implementation.

Although all tax departments are within the Ministry of Finance, historically there has been very little interaction between the Income Tax, Sales Tax, Customs and Property Tax Departments. MCTC will provide a comprehensive set of tax services to large taxpayers that interact with the sales tax, corporate tax and customs. The MCTC provides a variety of services, including advanced clearance of imports through customs, which it does in conjunction with its 'advance stations' at each port. Its goals are to reduce taxpayer burden, improve voluntary compliance, and increase operational and management effectiveness. The Center is active in developing new procedures for coordinated audits, export refunds and a range of web-based services. The MCTC represents the first step in the integration of tax administration in Egypt.

The objectives of MCTC include the development of an improved "tax culture" to increase voluntary compliance through the adoption of less burdensome and more transparent administrative processes and by improving taxpayer services. It is also to create a model department that introduces new concepts and innovative procedures that improve administrative practices and professionalizes the civil service in the tax and customs departments.

Expected Results:

The CTA has provided very extensive assistance for the creation of the center including: developing recommendations for its organizational structure, staffing, and procedures; defining and meeting its IT requirements; and developing taxpayer and public awareness materials. The following list represents a summary of initial innovations planned for the MCTC:

- Coordinated Audit Case Selection/Prioritization/Depth & Quality of Audit
- Placement of an Audit Quality Review Staff within the Audit Department
- Centralizing enforced collection activities for all three tax departments and for MCTC functional departments.
- No Ma'mour (auditor) pre-review of tax returns prior to filing.
- Separate data base-combining data from the three departmental systems with additional data from MCTC.
- Enhanced Functional Reports (Audit, Collection, Appeals, Taxpayer Service, etc.) to improve operational management, and case tracking (case calendar feature)
- Improve anti-evasion operations through use of internal leads (Audit, Collection, etc.) and information gathering activities

- Burden Reduction Initiatives to save taxpayer time, money and effort and increase customer satisfaction (mailing returns to taxpayers, computer generated notices, business center services, etc.)
- Customs pre-arrival clearance facilitation and linkage with major ports of entry
- Enhanced taxpayer assistance and educational services (publications, training, Internet, etc.).
- Permanent Appeals Committees within Legal Affairs/Appeals Department.
- Anti-Evasion does not perform audit or enforced collection.
- Appeals will refer cases back to Audit if the taxpayer introduces facts or substantiation not previously provided to the Audit Department.
- Supplemental incentive pay system based on evaluations of the quality of employee work

Findings:

1. The MCTC was established on July 1, 2003 and officially opened on September 14, 2003 and currently deals with around 300 taxpayers. The establishment of MCTC was initiated by the Minister of Finance after the review of taxpayers' problems[25] and the revenue impact of these problems and following a CTA-sponsored study tour by senior MOF officials to the Netherlands. The Center was established as a pilot study to deal with the three tax departments (Sales Tax, Income Tax, and Customs Duties). Some unique features of the MCTC include the following:

    - MCTC provides one-stop-service and is accessible via walk-in, phone, mail and internet connections

    - Taxpayer is given a unique taxpayer identifications number and all his/her tax and customs files are consolidated using this identification number

    - Taxpayers are audited by a team of auditors from each tax department

    - Appeals committees will provide better/faster/more accurate referrals to/from anti-evasion, audit, and collection departments.

    - Appeals will refer cases back to Audit if the taxpayer introduces facts or substantiation not previously provided to the Audit Department.

    - Anti-Evasion will coordinate with the Audit and Collection Departments to obtain the physical evidence (false invoices, fictitious suppliers, transfer of inventory, etc.)

2. Although a nascent organization, MCTC is a professionalized and integrated tax administration that has considerably reduced transaction costs for taxpayers. For example,

[25] The Executive Director of MCTC identified several problems faced by taxpayers before the establishment of the center. First, the clearance of goods from Egyptian ports took between 15 to 21 days. With MCTC facilitation it now takes less than one day. Second, auditors took approximately 4 months to inspect a file (1 month for the Sales Tax and 3 months for the Income Tax). However, in the MCTC it takes only 3 weeks. Third, the relationships between taxpayers and the tax departments were antagonistic. MCTC seeks to be taxpayer friendly and can be reached by phone, mail and internet.

MCTC customs facilitation has reduced both time and cost of goods clearance from the associated ports. Customs clearance time has been reduced from between 15 to 21 days to less than a day. Because the customs officers at the port accept the goods classifications and the associated charges importers pay only the amount of custom duties negotiated with MCTC. In addition, the integration of sales tax and income tax audits has also shaved off more than 3 months for auditing and assessing tax liabilities. What used to take 4 month now takes approximately 3 weeks as a result of both the sales and income tax audits being conducted simultaneously by a team of auditors. In addition, since tax assessors and auditors have decision-making authorities tax liabilities are negotiated and settled very quickly. In addition, because tax assessments and audits are current, cost of late payment and other penalties are avoided.

3. MCTC has employed the cream of the crop from each tax department. Extensive training was provided to these employees to professionalize them more than the other tax department employees. However, these MCTC employees are still tied to the existing remuneration and incentive schemes in their parent departments. Change is needed to sustain the professionalism and enthusiasm of these employees. Perhaps their incentive scheme could be tied to taxpayers' satisfaction scores and increases in voluntary tax compliance (i.e., timely filing and payment of the correct tax liability amount).

4. Automation of the MCTC is almost complete. MCTC can now generate consolidated management reports on arrears, collections, and returns.

Conclusions:

- While the CTA cannot claim credit for introducing the MCTC concept, it was flexible enough to recognize that the MCTC was an efficient alternative to achieving CTA objectives. Consequently, BearingPoint's technical expertise was put to full use in helping the MOF establish the Center, set up its systems and procedures and train its staff. Senior MOF interlocutors stated that the CTA provided support essential to the timely and successful establishment of the MCTC.

- The MCTC is an alternative concept for unifying and integrating the Egyptian tax systems. It could also serve as a vehicle for creating a modern tax administration system. However, its long term viability and success is critically dependent on the creation of an appropriate incentive scheme for the staff.

- Exposure to how effectively and efficiently taxes are administrated in other developed countries coupled with the strong political will of senior MOF officials to reform the tax system resulted in the creation of the MCTC.

- As more and more taxpayers join MCTC, Egypt will shift toward a more unified and integrated tax system without requiring massive reorganization of the tax departments.

- Trained, knowledgeable, and professional tax officers, empowered to make decisions, can substantially reduce transaction cost for taxpayers and enhance taxpayer voluntary compliance. In addition, credibility of the MCTC is critically dependant on skills, knowledge and professionalism of MCTC management and staff.

CHAPTER FIVE: MINISTRY OF FINANCE COMPONENT

The expected results stated under this component of the project essentially repeat or aggregate the expected results in each of the tax departments. However, BearingPoint was conscientious to brief and involve the Ministry of Finance in each step of the project and to provide computer equipment, software and training to meet particular needs at the Ministry level.

Task 1: Research Studies

Expected Results:

- Develop a tax reform package that includes a set of coordinated tax policies and draft legislation in corporate tax policy, income tax policy, and sales tax policy.
- Develop a coordinated administrative, operational, and procedural reform package for the offices of corporate tax administration, income tax administration, and sales tax administration.
- Prepare and submit a prioritized implementation plan for the above policy and administrative reform packages.

Findings:

1. As noted elsewhere in this report, the comprehensive policy and administrative reform packages were delivered to the MOF and relevant departments in June 2000. At the Ministry level, the focus of attention was the harmonization and coordination of the total reform package including the elimination of stamp taxes as the sales tax expands. Presentations, briefings and discussions were held at the Ministry level for the Minister and his senior taxation staff on the overall program as well as on a number of the important specific reforms. The project prepared an implementation plan for the program and, ultimately, the draft legislation packages.

2. In addition, at the Minister's request, discussion papers on special topics were prepared for and given to the Minister. The topics included the system of additions and deductions, personal and employment-related deductions, penalties and interest, and stamp duties.

3. The project also provided the Ministry with alternative organizational designs for a proposed new Economic Research Department in the Office of the Minister. The contractor also helped screen potential candidates for the positions in this new department.

4. Throughout the project, BearingPoint maintained a close working relationship with the Minister and his staff. In our interview with the Minister, the evaluation team found him to be exceedingly well informed on the status and objectives of every component in the project. In addition, he described a clear vision of what he had wanted the project to help him achieve; that is, a modern, cost-effective, depersonalized tax administration managing an equitable and efficient tax structure.

Conclusions:

The expected results as stated above were fully met. However, political considerations outside the control of the MOF as well as internal bureaucratic inertia have impeded implementation of the reform program.

Task 2: Training

Expected Results:

- ♦ Develop a needs assessment and training plan for all in-country as well as out-of-country training.
- ♦ Continue the training initiatives of Public Finance Administration Project through modernization of the training centers in both departments and upgrading the capabilities of existing centers.

Findings:

The training needs assessments and plans for all departments and for the Ministry itself were completed. The project also provided a senior Egyptian economist to facilitate the start up of the new Economic Research Department in the Office of the Minister. Training on the econometric software package "Eviews" was also provided.

Conclusions:

The expected results as stated above were fully met.

Task 3: Commodity Procurement

Expected Results:

- ♦ Develop a commodity procurement plan for both departments and the Ministry of Finance's office. The commodities to be ordered will be in two categories: computers and peripherals; and training aids and equipment. The plan will include, but not be limited to:
  - ▪ A general description of the commodities, their usage and the number of each to be ordered;
  - ▪ An implementation schedule for ordering, purchasing, and shipping of commodities;
  - ▪ Administrative mechanism to be used for administering the procurement plan.

Findings:

The project procured 23 desk top computers, three servers, printers, a scanner and software for the new Economic Research Department in the Office of the Minister. In particular, the project procured the "Eviews" econometric software for this department.

Conclusions:

The expected results as stated above were fully met.

CHAPTER SIX: CONCLUSIONS

This evaluation has primarily tracked the expected results as stated in the contractor's Scope of Work. However, the activity is larger than the contractor's Scope of Work and it includes the objectives of USAID and the GOE in agreeing to the activity in the first instance. It also includes the assumptions and common understandings on both sides that certain outcomes were desired and expected from the resources provided through the contractor.

The findings indicate that the contractor competently and comprehensively provided all of the services expected at the start of the activity. Therefore, from the planned inputs perspective, the project must be judged a success. However, in terms of the overall outcome of this assistance, the activity achieved mixed results. Specifically, there has been essentially no progress in furthering tax policy reform, as the relevant legislation has not yet reached the Peoples' Assembly for passage. The majority of income taxpayers must still deal with a vast, inefficient and out-of-date bureaucracy that has shown itself slow to adopt new methods and procedures. Automation and essential management information systems have not yet become the backbone of income tax administration.

However, there has been important progress in increasing revenues as a result of the extension of the GST to the wholesale and retail sector. Also, the management and administrative picture is brighter on the sales tax side as the department is relatively new and quicker to adopt change. It was created on the basis of a modern tax department and has no past legacy to overcome.

The CTA has imparted substantial technical and managerial skills through training and an important advancement has been made in automation.

The CTA responded flexibly and competently to new MOF concepts, particularly in supporting the establishment of the MCTC.

As the evaluation pointed out, in some cases the less than desired results may have arisen from the impingement of other priorities on a government heavily involved with a variety of reform issues and other concerns. Bureaucratic inertia may have also played a part, although bureaucratic innovation also accounts for the activity's successes. With this overview in mind, the findings of our evaluation of the CTA suggest the following conclusions:

1. Technical assistance for tax policy reform has essentially been completed.

The policy issues and their supporting arguments are on the table and are well known to the MOF and the GOE. There is little "new ground" to break. The consulting team delivered all that was expected in the area of policy. The lingering question, then, is "Was there anything more (or different) that the consulting team could have done to speed up adoption of reforms?" Our answer to this question is no. The consulting team was contracted to provide state-of-the-art technical analysis and advice. The assumption in this and many other technical assistance projects is that the clarity and insight emerging from comprehensive, high quality analysis and advice educates and compels the counterpart to take the right course of action. It is quite clear from this project that this assumption is erroneous. This leads to a second conclusion.

2. If the reform effort is to be moved up on the list of priorities, the project needs to have access to alternative or additional methods of coalition building than those solely provided by the technical arguments of the contractor, however compelling they may be in terms of sound economics.

The promulgation of new policies in areas that have a significant public impact, such as taxation, requires, at a minimum, that those affected do not disagree with the policy change to the point where they form a political coalition to resist the change. The ideal situation would be that a political coalition forms in support of the reforms, but this is unlikely when the reform seeks greater tax coverage. The CTA was designed on the premise that a good technical assistance contractor would convince the MOF who would, in turn, convince the government decision makers outside the MOF who would, in turn, forge the necessary political acceptance or support among the public. It appears that this linkage is a weak and time consuming approach, as evidenced by the CTA experience. The effort to convince the people needed to form the political coalition in support of new tax policies required more time than the project provided and may have required more social policy justification than that provided by the technical arguments submitted by the contractor.

A concerted "policy dialogue" between the GOE and the US Mission, with the help of other donors and international institutions, may have accelerated tax reform, but officials in these agencies must ration their "dialogue" efforts among many other program objectives. Even the Ministry of Finance itself, when dealing with the larger GOE, has competing priorities when one considers its responsibilities for policy reforms on the expenditure side of the budget. One has no assurance that a senior MOF official who accepts a reform proposal on the basis of sound technical arguments will, the next day, advocate the reform at the next higher level. The next day or the next week or the next month may be filled with other priorities.

With respect to reorganization, the findings suggest;

3. Given its problems and the broader needs of taxpayers, further efforts to reorganize the Tax Department internally would appear to be a costly and somewhat futile exercise. An alternative conceptual approach as seen by the Model Customs and Tax Center offers more promise as a modern tax authority than a stand-alone, reorganized Tax Department, although the concept has not yet been fully tested in Egypt.

The MCTC approach to building a modern tax authority has two distinct advantages. First, it provides the opportunity to develop a new "corporate culture", which is far less expensive to do than trying to change an existing and deeply rooted "corporate culture". Second, it provides a better way to coordinate and integrate the functions of the various tax departments than is likely to occur even if each tax department were fully reorganized and modernized.

The success of the experimental MCTC does, however, require the MOF to adjust several macro-level policies of taxation and tax administration. Specifically, the MOF needs to fully embrace the concept that tax administration should be built around taxpayer self-assessment combined with incentives that promote honesty. These contrasts with today's practice of having the tax authority determine the levy with the tax return merely providing some supporting information.

A second macro-level policy that needs changing is the method of calculating the incentive pay for employees. The current incentive is based on maximizing revenue. This is not fully compatible with the MOF's desire to ensure an accurate and fair levy of the tax for each taxpayer. If accuracy and fairness is the objective, the incentive needs to shift from a quantity basis to a quality basis. The expansion of revenue would then rely on an expansion of the taxpaying base, increased taxpayer compliance and/or an increase in the tax rate.

Related to management practices and systems, the findings suggest;

4. A selective audit system is essential to improving the cost-effectiveness of the tax authority. However, there should be no expectation that the MOF will be able to adopt one until there is a functioning system of taxpayer incentives for more honest self-assessment. Given the state of development of the risk assessment model, the data and the other influencing factors, a selective audit approach may require three to five more years to become operational.

5. The sine quo non of a modern tax authority is it reliance on electronic data processing. The Tax Department may be only 50 percent and the Sales Tax Department 75 percent of the way in terms of hardware and software, which, at the present time, seriously limits the full use of the technology. Also, if the MOF is unable to continue the pace of expanding system coverage, the training and new management practices that depend on ADP will not be fully utilized.

6. Both the Sales Tax Department and the Tax Department have a genuine (and large) appetite for training in tax audit, collection and management techniques employed by modern tax authorities in the industrial countries. This training is generally not available in Egypt.

7. Training will not produce the desired effect until it is tied to tax officers' career paths and matched with appropriate remuneration and incentive schemes.

CHAPTER SEVEN: RECOMMENDATIONS

On the basis of the findings and conclusions, the evaluation team offers the following recommendations to USAID:

1. Any further assistance in the area of organizational development should focus exclusively on helping the MOF succeed in its experimental MCTC, the new "Professional Tax Center" and other such integrated service centers that are planned. If one looks back at USAID/Egypt's success rate in institution building, the record shows that the "success" column contains relatively more new institutions and the "failure" column contains relatively more long established departments. The reorganization of the Tax Department as originally proposed by BearingPoint should not be pursued for the reasons noted in the Conclusions of this report.

2. Should USAID consider further assistance to the MOF's program of modernizing taxation in Egypt, the assistance package need not include tax policy assistance. If the full exclusion of tax policy assistance is considered too restrictive, the program or activity could include limited periodic visits by a tax policy expert to assess progress and answer MOF questions, should any arise. As noted in the full evaluation report, the reform agenda provided by the CTA and its predecessor PFAP constitute ample identification of the remaining policy shortcomings in the tax system today. Also, there is ample analysis and economic justification for the recommended courses of action. The full time presence of policy expertise would not be efficacious in terms of alternative uses of program resources or in helping speed up the approval of the reform within the GOE.

3. There is and will continue to be a need for training, particularly to expose the technical personnel in audit, collections, anti-evasion and data management departments to new, sophisticated methods and technology. While some of this can be done through offshore training, the level of English may require instructors to be brought here with simultaneous translation facilities provided. In addition, there continues to be an immediate need to help managers understand and become familiar and comfortable with the MIS and the reports it generates so that these become valued management tools. In keeping with the previous recommendation, the training should focus on personnel being assigned to the new tax centers.

4. There remains a significant need to upgrade the ADP system. The full burden is likely beyond the interest of USAID. However, any future assistance in taxation should insure that the ADP needs of the new centers are met.

Finally, it was pointed out to us that the experts needed at this stage, particularly on sales taxation, should be more technically specialized than those needed at the start of the program in 1989. The evaluation team agrees with this view. However, the USAID salary cap may inhibit a contractor from employing the appropriate expertise. If further assistance is to be offered to the MOF, USAID should be prepared to exceed the consultant salary cap on a case by case basis.

APPENDIX I: INTERVIEWS CONDUCTED

Ministry of Finance:

- Medhat Hassanein, Minister of Finance

Tax Department:

- Hosni Gad, Commissioner, Income Tax Department
- Fathi Hammam, Director, Anti-evasion
- Sabri Khattab, Director, Audit & Collection
- Fathi Abdel Aziz, Director Central Department, IT Department
- Nadia Hafez, Director, Training Department
- Faten Mohamed Ismail, Director, Taxpayer Assistance
- Sayed Gouda, Economic Researcher

Sales Tax Department:

- Mahmoud Ali, Commissioner, Sales Tax
- Reda Saadan, MCTC Executive Director
- Mohamed Badea, Registrant's Assistance
- Hamdy El Essawi, Audit Planning
- Fayza Fouad, Undersecretary, General Sales Tax Department, Training Center

Corporate Tax Activity, BearingPoint:

- Darwin G. Johnson, Senior Vice President
- Richard Clayton, Chief of Party
- Bedro Valdes, Senior Resident Advisor, Information Technology
- Fatos Qendro, Senior Resident Advisor, Information Technology
- Lew Baurer, Senior Resident Advisor, Model Customs and Tax Center
- Peter Bruges, Resident Advisor, Sales Tax
- Phyllis Hodgkins, Senior Resident Advisor, Direct Tax
- Charolotte Cerf, Senior Resident Advisor, Tax Payer Service

United States Agency for International Development (USAID)

- Anthony Chan, Sector Policy and Privatization Division Chief
- Iman El Shayeb, Project Officer, Sector Policy and Privatization Division
- Paul Bruning, Economist, Sector Policy and Privatization Division
- John Morgan, Program and Impact Assessment Officer
- Glenn Rogers, Economist, Sector Policy and Privatization Division

American Chamber Tax Committee
Interviews with 16 companies, MCTC Clients
Interviews with non MCTC taxpayers

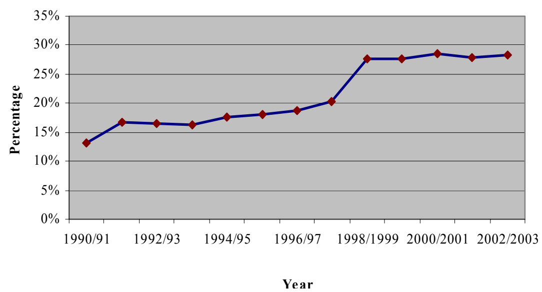
APPENDIX II: DATA TABLES AND GRAPHS

Table 1: Tax Revenues (1990/91-2002/03)

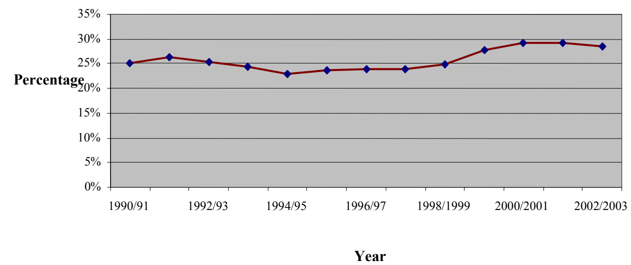
Item (In L.E. Billion)	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	00/1999	01/2000	2001/02	2002/03
Total Revenues	**28.6**	**41.4**	**46.7**	**52.6**	**55.7**	**60.9**	**64.5**	**68.0**	**69.4**	**73.6**	**74.6**	**75.3**	**82.6**
Current Revenues	**25.6**	**37.8**	**43.7**	**49.4**	**52.9**	**57.7**	**60.8**	**63.9**	**67.2**	**72.5**	**72.8**	**74.1**	**81.4**
Tax Revenues	**15.5**	**24.3**	**27.3**	**31.4**	**34.3**	**38.2**	**40.5**	**44.0**	**46.5**	**49.6**	**51.4**	**51.7**	**57.6**
Sales Tax (commodities & services)	3.4	6.3	7.2	8.1	9.3	10.5	11.3	12.9	18.6	20.1	20.8	20.6	23.1
Income Tax	6.4	10.0	11.1	12.0	12.1	13.7	14.6	15.3	16.7	20.1	21.2	21.6	23.2
*Others	5.7	8.0	9.0	11.3	12.8	14.1	14.6	15.7	11.2	9.4	9.3	9.5	11.3
GDP in current prices	**98.6**	**131.1**	**146.2**	**163.0**	**191.0**	**214.2**	**247.0**	**266.8**	**282.6**	**315.7**	**332.5**	**354.6**	**388.1**
Sales Tax as a percentage of the Current Revenues	**13.2%**	**16.7%**	**16.5%**	**16.4%**	**17.6%**	**18.1%**	**18.6%**	**20.2%**	**27.7%**	**27.7%**	**28.6%**	**27.8%**	**28.3%**
Income Tax as a percentage of the Current Revenues	**25.0%**	**26.4%**	**25.4%**	**24.3%**	**22.9%**	**23.8%**	**24.0%**	**24.0%**	**24.9%**	**27.7%**	**29.2%**	**29.2%**	**28.5%**
Sales Tax as a percentage of the Tax Revenues	**21.8%**	**26.0%**	**26.3%**	**25.8%**	**27.2%**	**27.3%**	**28.0%**	**29.4%**	**39.9%**	**40.5%**	**40.5%**	**39.8%**	**40.1%**
Income Tax as a percentage of the Tax Revenues	**41.3%**	**41.2%**	**40.7%**	**38.3%**	**35.4%**	**35.8%**	**36.0%**	**34.8%**	**36.0%**	**40.5%**	**41.3%**	**41.8%**	**40.3%**
Sales Tax as a percentage of GDP in current prices	**3.4%**	**4.8%**	**4.9%**	**5.0%**	**4.9%**	**4.9%**	**4.6%**	**4.8%**	**6.6%**	**6.4%**	**6.3%**	**5.8%**	**5.9%**
Income Tax as a percentage of GDP in current prices	**6.5%**	**7.6%**	**7.6%**	**7.4%**	**6.4%**	**6.4%**	**5.9%**	**5.7%**	**5.9%**	**6.4%**	**6.4%**	**6.1%**	**6.0%**
Tax Revenues as a percentage of Current Revenues	**60.5%**	**64.2%**	**62.6%**	**63.5%**	**64.8%**	**66.3%**	**66.7%**	**68.8%**	**69.3%**	**68.4%**	**70.6%**	**69.8%**	**70.7%**

Graph 1: Sales and Income Taxes as a Percentage of Current Revenues, Tax Revenues and GDP

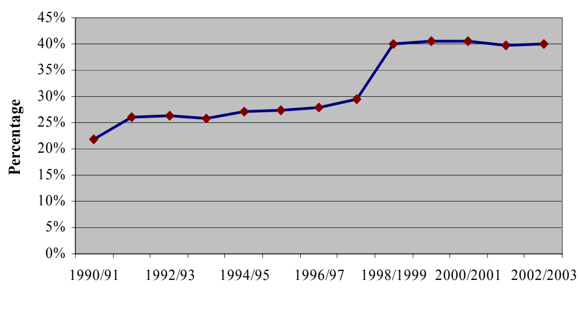
Sales Tax as a percentage of the Current Revenues from 1990/91 through 2002/03



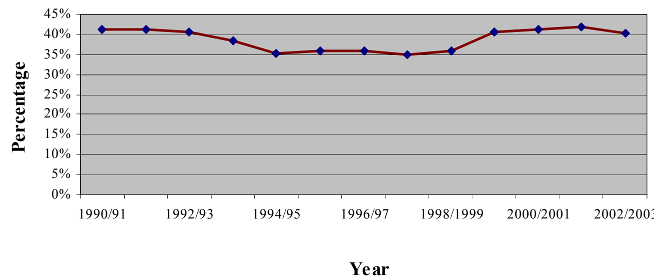
Income Tax as a percentage of the Current Revenues from 1990/91 through 2002/03



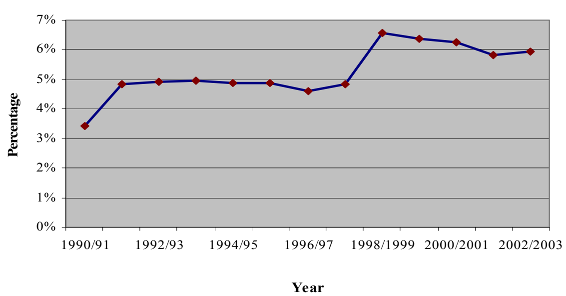
Sales Tax as a percentage of the Tax Revenues from 1990/91 through 2002/03



Income Tax as a percentage of the Tax Revenues from 1990/91 through 2002/03



Sales Tax as a percentage of the The GDP from 1990/91 through 2002/03



Income Tax as a percentage of the GDP from 1990/91 through 2002/03

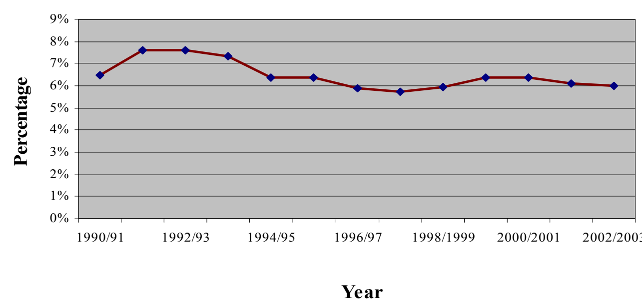


Table 2: Consolidated Fiscal Operations of the Central Government (1998/99-2002/03)

Item (In L.E. Million)	1998/99	1999/00	2000/01	2001/02	2002/03	Average Annual Growth Rate (1998/99 - 2002/03)	1998/99	1999/00	2000/01	2001/02	2002/03	Average Annual Growth Rate (1998/99 - 2002/03)
Total Revenue and Grants (A+B)	71,072	75,399	76,139	78,968	85,854	5.2%	91,812	97,672	101,051	104,042	115,467	6.4%
(A) Total Revenue	69,423	73,626	74,568	75,255	82,585	4.7%	90,163	95,899	99,480	100,329	112,198	6.1%
Current Revenue	67,207	72,504	72,776	74,060	81,435	5.3%	87,947	94,777	97,688	99,134	111,048	6.6%
Tax Revenue	46,543	49,621	51,358	51,726	57,550	5.9%	46,543	49,621	51,358	51,726	57,550	5.9%
Income Taxes	16,740	20,104	21,235	21,625	23,214	9.7%	16,740	20,104	21,235	21,625	23,214	9.7%
Goods and Services	18,584	20,085	20,793	20,580	23,066	6.0%	18,584	20,085	20,793	20,580	23,066	6.0%
International Trade	11,048	9,295	9,184	9,323	11,079	0.1%	11,048	9,295	9,184	9,323	11,079	0.1%
Other	171	137	146	198	191	2.9%	171	137	146	198	191	2.9%
Non-tax Revenue	20,664	22,883	21,418	22,334	23,885	3.9%	41,404	45,156	46,330	47,408	53,498	7.3%
Capital Revenue	2,216	1,122	1,792	1,195	1,150	-12.0%	2,216	1,122	1,792	1,195	1,150	-12.0%
(B) Grants	1,649	1,773	1,571	3,713	3,269	24.6%	1,649	1,773	1,571	3,713	3,269	24.6%
Total Exp & Net Lending (C+D)	79,995	88,600	96,121	101,153	101,153	6.6%	92,032	101,834	109,069	113,665	127,382	9.6%
(C) Total Expenditures	78,724	86,464	95,942	100,739	100,739	7.0%	84,906	92,950	105,086	106,506	120,162	10.4%
Current Expenditures	61,183	69,758	80,843	85,472	85,472	9.9%	67,365	76,244	89,987	91,239	103,747	13.5%
Wages & Salaries	19,562	22,180	25,217	28,238	28,238	11.1%	19,773	22,421	25,482	28,500	31,928	15.4%
Defense	8,107	8,516	9,731	10,218	10,218	6.5%	8,107	8,516	9,731	10,218	11,155	9.4%
Interest	16,406	18,597	20,907	22,903	22,903	9.9%	14,524	16,303	18,833	20,352	24,140	16.6%
Domestic	14,081	16,800	19,074	20,570	20,570	11.5%	12,199	14,506	17,000	18,019	21,119	18.3%
Foreign	2,325	1,797	1,833	2,333	2,333	0.1%	2,325	1,797	1,833	2,333	3,021	7.5%
Other	17,108	20,465	24,988	24,113	24,113	10.2%	24,961	29,004	35,941	32,169	36,524	11.6%
Capital Expenditures	17,541	16,706	15,099	15,267	15,267	-3.2%	17,541	16,706	15,099	15,267	16,415	-1.6%
(D) Lending-Repayments	1,271	2,136	179	414	414	-16.9%	7,126	8,884	3,983	7,159	7,220	0.3%
Overall Deficit/Surplus	-8,923	-13,201	-19,982	-22,185	-15,299		-220	-4,162	-8,018	-9,623	-11,915	

Source: Central Bank of Egypt (This data has been prepared according to the international classification agreed with the IMF as from 1998/99) . Average Growth Rates are based on RRSA team calculations.

Table 3: The State Budget Revenues (1990/91 - 1997/98)

The State Budget : Revenues								
(In L.E Million)	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98
Total Revenues	**28,559**	**41,406**	**46,703**	**52,567**	**55,719**	**60,893**	**64,498**	**67,963**
Current Revenues	**25,608**	**37,834**	**43,683**	**49,418**	**52,925**	**57,708**	**60,753**	**63,889**
Central Government	23,875	35,677	41,020	46,384	49,889	54,486	57,179	60,035
Tax Revenues	15,503	24,286	27,334	31,373	34,279	38,249	40,518	43,962
Tax on income and business profits	6,406	9,996	11,114	12,003	12,134	13,707	14,589	15,306
Tax on Property	2	5	8	12	21	24	3	0
Sales Tax (commodities & services)	3,373	6,324	7,191	8,080	9,333	10,450	11,325	12,925
Customs duties	3,267	4,588	5,009	6,120	7,017	7,911	8,125	8,886
Stamp duties	1,315	1,839	2,067	2,657	2,874	3,074	3,168	3,215
Other tax revenues	1,140	1,534	1,945	2,501	2,900	3,083	3,308	3,630
Non_Tax Revenues	8,372	11,391	13,686	15,011	15,610	16,237	16,661	16,073
Profits Transfers, from:	6,979	8,863	9,364	9,070	10,542	11,133	11,423	10,780
The Petroleum Authority	3,236	3,715	4,626	4,610	4,443	4,717	4,788	3,870
The Suez Canal Authority	1,361	3,015	3,013	2,610	3,132	3,015	2,828	2,940
The Central Bank of Egypt	1,792	1,556	968	1,200	2,072	2,318	2,587	2,617
Other Economic Authorities	590	577	757	650	895	1,083	1,220	1,353
Fees	321	475	459	963	1,220	1,359	1,427	1,483
Miscellaneous	1,072	2,053	3,863	4,978	3,848	3,745	3,811	3,810
Local Government	1,092	1,408	1,782	1,984	1,951	2,125	2,354	2,426
Services Authorities	641	749	881	1,050	1,085	1,097	1,220	1,428
Capital Revenues	**2,951**	**3,572**	**3,020**	**3,149**	**2,794**	**3,185**	**3,745**	**4,074**
Other Capital Revenues (Sales of Assets)	-	166	682	678	656	611	629	635
Investments (self-financing)	2,951	3,406	2,338	2,471	2,138	2,574	3,116	3,439

Source: Central Bank of Egypt Online Database (This data has been prepared according to the international classification agreed with the IMF as from 1998/99) .

Table 4: GDP at Factor Cost - By Economic Sector in Constant Prices – 1991/1992 and 1995/1996

Sectors	1991/1992			1995/1996			Average Annual Growth Rate %		
(In L.E. Million)	*Public*	*Private*	*Total*	*Public*	*Private*	*Total*	*Public*	*Private*	*Total*
GDP	50,300	80,269	130,569	55,510	97,216	152,726	2.6%	5.3%	4.2%
	38.5%	61.5%		36.3%	63.7%				
Commodity Sectors	24,302	41,071	65,373	27,277	49,084	76,361	3.1%	4.9%	4.2%
Agriculture	254	21,426	21,680	165	24,305	24,470	-8.8%	3.4%	3.2%
Industry & Mining	9,105	12,625	21,730	10,202	16,768	26,970	3.0%	8.2%	6.0%
Petroleum & Products	10,759	2,249	13,008	12,052	2,313	14,365	3.0%	0.7%	2.6%
Electricity	2,220	0	2,220	2,658	0	2,658	4.9%	N/A	4.9%
Construction & Building	1,964	4,771	6,735	2,200	5,698	7,898	3.0%	4.9%	4.3%
Productive Services Sectors	16,526	27,080	43,606	17,035	33,639	50,674	0.8%	6.1%	4.1%
Transport & Communication	4,540	4,170	8,710	5,116	5,379	10,495	3.2%	7.2%	5.1%
Suez Canal	6,125	0	6,125	5,621	0	5,621	-2.1%	N/A	-2.1%
Trade	2,230	19,500	21,730	1,742	24,194	25,936	-5.5%	6.0%	4.8%
Finance	3,215	1,330	4,545	4,109	1,800	5,909	7.0%	8.8%	7.5%
Insurance	46	30	76	62	42	104	8.7%	10.0%	9.2%
Restaurants & Hotels	370	2,050	2,420	385	2,224	2,609	1.0%	2.1%	2.0%
Social Services Sectors	9,472	12,118	21,590	11,198	14,493	25,691	4.6%	4.9%	4.7%
Real Estate Ownership	127	2,223	2,350	159	2,660	2,819	6.3%	4.9%	5.0%
Government Services	9,345	0	9,345	11,039	0	11,039	4.5%	N/A	4.5%
Personal services	0	9,895	9,895	0	11,833	11,833	N/A	4.9%	4.9%

Source: Central Bank of Egypt Online Database – Average Growth Rates are based on RRSA team calculations.

Table 5: GDP at Factor Cost - By Economic Sectors in Constant Prices – 1996/1997 and 2000/2001

Sectors	1996/1997			2000/2001			Average Annual Growth Rate %		
(In L.E. Million)	*Public*	*Private*	*Total*	*Public*	*Private*	*Total*	*Public*	*Private*	*Total*
GDP	76,501	162,778	239,279	73,708	215,131	288,839	-0.9%	8.0%	5.2%
	32%	68%		26%	75%				
Commodity Sectors	35,381	83,611	118,992	30,493	109,468	139,961	-3.5%	7.7%	4.4%
Agriculture	188	41,694	41,882	213	47,756	47,969	3.3%	3.6%	3.6%
Industry & Mining	11,352	32,031	43,383	7,063	50,752	57,815	-9.4%	14.6%	8.3%
Petroleum & Products	14,569	2,892	17,461	11,697	2,327	14,024	-4.9%	-4.9%	-4.9%
Electricity	4,172		4,172	5,557	29	5,586	8.3%	N/A	8.5%
Construction & Building	5,100	6,994	12,094	5,963	8,604	14,567	4.2%	5.8%	5.1%
Productive Services Sectors	22,034	55,526	77,560	20,575	76,584	97,159	-1.7%	9.5%	6.3%
Transport & Communication	6,152	10,048	16,200	3,494	16,527	20,021	-10.8%	16.1%	5.9%
Suez Canal	6,495		6,495	6,551		6,551	0.2%	N/A	0.2%
Trade	2,325	39,128	41,453	1,846	50,865	52,711	-5.2%	7.5%	6.8%
Finance	6,410	2,990	9,400	8,461	4,162	12,623	8.0%	9.8%	8.6%
Insurance	107	75	182	141	104	245	7.9%	9.7%	8.7%
Restaurants & Hotels	545	3,285	3,830	82	4,926	5,008	-21.2%	12.5%	7.7%
Social Services Sectors	19,086	23,641	42,727	22,640	29,079	51,719	4.7%	5.8%	5.3%
Real Estate Ownership	186	4,189	4,375	198	5,492	5,690	1.6%	7.8%	7.5%
Government Services	18,900		18,900	22,442		22,442	4.7%	N/A	4.7%
Personal Services	0	19,452	19,452	0	23,587	23,587	N/A	5.3%	5.3%

Source: Central Bank of Egypt Online Database – Average Growth Rates are based on RRSA team calculations.

Table 6: GDP at factor cost - by Economic Sectors in Constant Prices 2001/02 and 2002/03

Sectors	2001/2002			2002/2003			Average annual growth %		
(In L.E. Million)	***Public***	***Private***	***Total***	***Public***	***Private***	***Total***	***Public***	***Private***	***Total***
GDP	90,133	255,639	345,772	93,465	262,959	356,423	3.70%	2.9%	3.10%
	26.1%	73.9%	100.0%	26.2%	73.8%	100%			
Commodity Sectors	23,967	156,339	180,306	23,958	160,285	184,242	0.00%	2.5%	2.2%
Agriculture	228	58,141	58,369	233	59,770	60,003	2.20%	2.8%	2.8%
Industry & Mining	9,471	60,614	70,084	9,564	62,326	71,890	1.00%	2.8%	2.6%
Petroleum & Products	1,585	27,775	29,360	1,621	28,562	30,183	2.30%	2.8%	2.8%
Electricity	5,814	119	5,933	6,005	392	6,397	3.30%	229.1%	7.8%
Consturction & Building	6,870	9,690	16,560	6,535	9,235	15,770	-4.90%	-4.7%	-4.8%
Productive Services Sectors	28,044	74,800	102,844	30,330	77,728	108,059	8.20%	3.9%	5.1%
Transport & Communication	4,000	19,753	23,753	4,128	20,779	24,906	3.20%	5.2%	4.9%
Suez Canal	8,199	0	8,199	10,091	0	10,091	23.10%	N/A	23.1%
Trade	1,803	41,156	42,959	1,822	41,964	43,786	1.10%	2.0%	1.9%
Finance	13,753	7,369	21,122	14,196	7,406	21,602	3.20%	0.5%	2.3%
Insurance	197	157	354	0	0	0	-100.00%	-100.0%	-100.0%
Restaurants & Hotels	92	6,365	6,457	94	7,579	7,673	2.20%	19.1%	18.8%
Social Services Sectors	36,599	24,501	61,100	37,578	24,946	62,524	2.70%	1.8%	2.3%
Real Estate Ownership	572	13,351	13,923	576	13,453	14,029	0.70%	0.8%	0.8%
Government Services	35,269	0	35,269	36,222	0	36,222	2.70%	N/A	2.7%
Personal Services	758	11,150	11,908	781	11,493	12,274	3.00%	3.1%	3.1%
Water (non-add)	1,522	0	1,522	1,598	0	1,598			

Source: Central Bank of Egypt Online Database – Growth Rates are based on RRSA team calculations.

Table 7: Balance of Payments – Current Account (1995/96 – 2002/03)

(In US $ Million)	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/2001	2001/2002	2002/2003	Growth 1995/96-2002/03
Trade Balance	**-9,498**	**-10,219**	**-11,770**	**-12,563**	**-11,472**	**-9,363**	**-7,523**	**-6,616**	
Export Proceeds**	**4,609**	**5,346**	**5,129**	**4,445**	**6,388**	**7,078**	**7,121**	**8,205**	78.0%
Petroleum	2,226	2,578	1,729	1,000	2,273	2,632	2,381	3,161	42.0%
Non Oil Export	2,383	2,768	3,400	3,445	4,115	4,446	4,740	5,044	111.7%
Import payments**	**-14,107**	**-15,565**	**-16,899**	**-17,008**	**-17,860**	**-16,441**	**-14,644**	**-14,821**	
Petroleum						-3,172	-2,477	-2313	
Non Oil Imports						-13,269	-12,161	-12508	
Services (net)	**5,791**	**6,192**	**4,691**	**5,970**	**5,631**	**5,588**	**3,880**	**4,890**	
Receipts	**10,636**	**11,240**	**10,455**	**11,026**	**11,427**	**11,697**	**9,618**	**10,441**	-1.8%
Transportation, of Which	2711	2535	2457	2637	2635	2704	2715	2964.8	9.4%
Suez Canal Dues	1885	1849	1776	1771	1781	1843	1820	2236.2	18.6%
Travel	3009	3646	2941	3235	4314	4317	3423	3796.4	26.2%
Investment Income	1829	2052	2081	1933	1833	1850	938	641.3	-64.9%
Government Services	285	216	303	308	110	190	188	252.8	-11.3%
Other Receipts	2802	2791	2673	2913	2535	2636	2354	2786.1	-0.6%
Payments	**-4,845**	**-5,048**	**-5764**	**-5056**	**-5796**	**-6109**	**-5737.9**	**-5551.8**	14.6%
Transportation	-203	-242	-362	-377	-457	-429	-419	-393	93.3%
Travel	-1335	-1333	-1307	-1104	-1028	-1054	-1208	-1372	2.8%
Investment Income, of which	-1291	-1085	-868	-928	-901	-778	-842	-805	-37.6%
Interest Paid	-1195	-995	-716	-789	-770	-728	-689	-626	-47.6%
Government Expenditures	-437	-511	-856	-511	-467	-588	-660	-455	4.2%
Others Payments	-1579	-1877	-2371	-2136	-2943	-3260	-2609	-2526	60.0%
Balance of Goods & Services	**-3,707**	**-4,027**	**-7,079**	**-6,593**	**-5,841**	**-3,775**	**-3,643**	**-1,726**	
Transfers	**3,522**	**4,146**	**4,601**	**4,869**	**4,679**	**3,742**	**4,253**	**3,609**	2.5%
Official (net)	724	890	883	1,097	932	769	1,144	664	-8.3%
Private (net)	2,798	3,256	3,718	3,772	3,747	2,973	3,109	2,946	5.3%
Balance of Current Account	**-185**	**119**	**-2,478**	**-1,724**	**-1,162**	**-33**	**610**	**1,883**	

Source: Ministry of Foreign Trade, August 2003
* 2001/2002 full year aggregates are preliminary, and some lines may not be consistent with the semi annual and quarterly data in tables 22 and 24.
** Starting 1996/97, trade data includes exports and imports of Free Zones Areas.
Note: data in this table are based on banking sector compilation based on cash transactions. It may differ from data compiled by CAPMAS which are based on Custom Authorities' records of movement of goods.

Table 8: Balance of Payments – Capital Account (1995/96 – 2002/03)

(in US $ million)	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/2001	2001/2002	2002/2003
Capital & Financial Account	**1,017**	**2,041**	**3,387**	**919**	**-1,199**	**-542**	**-964**	**-2733.8**
Direct Investment Abroad	-15	-47	-137	-56	-43	**-27.3**	**-15.2**	**-30**
Direct Investment In Egypt (net)	627	770	1,104	711	1,656	**509**	**428**	**700.6**
Portfolio Investment Abroad	--	--	-56	-43	-12	**-5**	**-3**	**-15.8**
Portfolio Investment In Egypt (net)	258	1,463	-248	-174	473	**260**	**45**	**-187**
Other Investment (net)	**148**	**-145**	**2,724**	**481**	**-3,273**	**-1,280**	**-1,493**	**-3201.6**
Net Borrowing	89	225	858	191	492	268	881	**-74.6**
M&L Term Loans	-75	-113	-54	-339	-532	-559	-585	**-586.5**
Drawings	472	416	525	273	194	268	340	644.9
Repayments	-547	-528	-579	-611	-726	-827	-925	-1231.4
MT Suppliers Credit	-283	-251	322	-110	-95	-112	-207	**-340.1**
Drawings	56	77	547	88	236	77	261	42.5
Repayments	-339	-328	-225	-197	-331	-189	-468	-382.6
ST Suppliers Credit (net)	447	588	591	639	1,119	939	721	**1070.2**
Bonds*	--	--	--	--	--	--	952	**-218.2**
Other Assets	237	-1,590	97	143	-3,112	-2,281	-1,835	**-3067.7**
CBE	--	--	--	-17	-22	-17	12	-32
Banks	--	--	--	-2,126	-198	1,034	227	-493.4
Other	--	--	--	-1,966	-2,891	-3,298	-2,174	-2542.3
Other Liabilities	-177	1,221	1,769	147	-654	739	-439	**-59.3**
CBE	--	--	--	-200	-3	495	7	3.7
Banks	--	--	--	347	-651	238	-446	-63
Net Errors & Omissions	**-261**	**-247**	**-1,043**	**-1,312**	**-644**	**-296**	**67**	**1396.7**
Overall Balance	**571**	**1,913**	**-135**	**-2,117**	**-3,027**	**-871**	**-456.4**	**546**
Change in Reserve Assets (increase = -)	-571	-1,913	135	2,117	3,027	871	456.4	**-546**

Source: Ministry of Foreign Trade, August 2003

* Includes the Eurobond issued in July 2001 of US$1.5 billion. The figures above exclude amounts held by resident institutions.

APPENDIX III: AN OVERVIEW OF EGYPT'S ECONOMY[26]

Egypt's economy passed through two distinct phases between 1995 and 2003. The first, from about 1995 to 2000[27], exhibited strong economic growth and substantial structural change as a result of significant economic reforms implemented in the late 1980's and early 1990's. From 2000 onwards, however, growth and structural change slowed, largely from the effects of global recession and regional political uncertainties.

Data from 1996[28] to 2000 show the average annual rate of real economic growth was 5.2 percent, unprecedented when compared with the prior three decades of Egypt's economic performance and quite respectable compared to other countries in similar circumstances. Industrial production and mining, electricity, finance and insurance grew by more than 8 percent annually while tourism and real estate ownership followed closely at over 7 percent. More importantly, from a structural perspective, there was a dramatic shift away from state provision of goods and services to private sector production. [29] The real value of public sector production in industry and mining, transportation and communication, trade and tourism declined during the period while the private sector's provision of these goods and services grew substantially. During this period, the private sector became an important player in the provision of telecommunication services and initiated its first involvement in the production of electricity. Overall, the private sector increased its recorded share of GDP by 6.5 percentage points, to 74.5 percent of GDP.[30]

From July 2001 through June 2003, the average annual rate of growth slowed to 3.2 percent. With no significant reversals in the domestic economic reform program, Egypt's expansion was constrained by world recession and political insecurity in the Middle East. In the commodity sectors, the public sector showed no overall growth while private sector growth dropped from an annual rate of 7.7 percent to only 2.5 percent. Structural change continued

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[26] This Appendix is a revision of a description produced for the evaluation of USAID's Private Sector Commodity Import Program, conducted in December 2003.

[27] Dates refer to the start of the Egyptian fiscal year beginning July 1.

[28] Data from 1995 were not used because they are based on constant prices for 1990/91, which would have introduced data discontinuities.

[29] Egyptian data report production as "public sector" or "private sector" according to the law under which the production is organized. Governmental entities and production organized under public sector company law is reported as "public sector." Production organized under a private sector company law is reported as "private sector." However, there are a number of government owned entities (some rather large) that are organized under private sector law and are thus included in the data under the "private sector" heading. There is no firm estimate of the size of the government's ownership of the private sector. In banking and tourism, the government's share of "private sector" production has clearly shrunk. In industry, it has shifted from active management toward portfolio investment. Government owned companies in the "private sector" no longer seem to have special benefits or privileges as a result of the government's equity interest.

[30] See Annex II Table (5). Data used to calculate sector shares and growth rates within each of the two periods are based on constant prices for each period. The first period uses 1996/97 prices for the Egyptian fiscal years from 1996 through 2000. Data for 2001and 2002 are stated in 2001 prices. Consequently, real growth rates between the two periods cannot be calculated. In addition, the updating of the constant price base produces a slight shift in the relative importance of sectors and the shares that are public and private. Thus the private sector's contribution to GDP may not have actually declined between 2000 and 2001. Rather, the 2001 data based on a more current constant price may more accurately reflect the relative worth of GDP components in 2001 than does the 1996/97 base captured for the year 2000.

with noticeable expansion of private sector activity in electricity and insurance, but the value of this expansion was a small component of GDP. Despite short-term setbacks after September 11, 2001 and during the Iraq conflict, the growth in tourism, now primarily in the private sector, remained high. However, overall, the government share of GDP remained essentially unchanged due to expanded government services and increased revenue from the Suez Canal[31].

Balance of Payments

Egypt's balance of payments account is characteristic of emerging market economies, in that imports significantly exceed exports for some period after changes in policy and law shifted the economic paradigm from a closed, import substitution system to an open market economy. This reflects not only pent-up demand, but also the lag between importing capital goods and raw materials and the export of their products. It also reflects the time required to implement a number of structural changes in the economy, such as shifting from domestic market standards to those required for international trade. Between 1994 and 1998[32], the balance of trade worsened. Petroleum revenues declined but were not compensated for by the continuous rise in non-petroleum exports. In addition, important tourist revenues in 1997 and 1998 were far below their growth trend line, reflecting perceived security threats in the region. However, with exports rising and imports shrinking, the balance of trade improved for the remainder of the period and the current account balance became positive in 2000. It has remained positive despite the sharp, temporary decline in tourism revenues after the events of September 11, 2001. Since the year 2000, non-petroleum exports have become the single most important source of current account revenues, surpassing tourism and worker remittances, although tourism should rebound to the lead position as the perceived security situation in the region improves[33].

On the capital account, the structural change in the economy occurring between 1995 and 1999 is reflected in the significant rise in new foreign direct investment inflows, which peaked at $1,656 million in 1999. World recessionary conditions reduced this source of capital by more than 60 percent for the next several years, but some slight recovery occurred in 2002. Similarly, but lagged by one year, Egypt's earnings from investments abroad declined by a total of almost 60 percent[34].

The Budget

Since well before the economic reform program was initiated, the GOE has struggled to rein in expenditures and increase revenues. Budget imbalances became acute in the 1980's and, along with chronic foreign exchange shortages and very low levels of investment, were a fundamental part of the incentive to undertake reform. Since the early 1990's, the consolidated budget deficit has declined and is now (barely) in the manageable range. On the revenue side, the sales tax has become a principal source of revenue and the importance of

[31] See Annex II Table (6)
[32] Dates refer to the start of the Egyptian fiscal year beginning July 1.
[33] See Annex II Table (7)
[34] See Annex II Table (8)

customs revenue has been reduced, consistent with the GOE's policy favoring export-led growth. On the expenditure side, there has been a sharp curtailment in public sector capital expenditures. Also, some categories of budget expenditures are now partly undertaken by the private sector, such as in electricity (the Build, Own, Operate and Transfer program—BOOT) and in telecommunications.

Nevertheless, the budget remains in deficit and the GOE continues to search for new sources of revenue, believing that significant expenditure cuts would be socially and politically unwise. The problem has been exacerbated since 2001 as the recession negatively impacted sales tax receipts while government-provided services and debt amortization rose[35].

Foreign Trade

During the 1990's, foreign exchange became readily available to finance imports compared to the previous decade. By the end of the decade, Egypt's foreign currency reserves were sufficient to finance well over a year's worth of imports. However, with the recession and the decline in tourist revenues, foreign exchange is seen to have become scarcer, and the CBE has taken measures to prioritize imports.

GOE authorities feel that luxury imports have become excessive and contribute to the tight foreign exchange situation. For example, there has been a 600+ percent rise since 1995 in the import category of footwear, headgear, umbrellas and artificial flowers, and imported luxury cars are very visible. While these items still constitute a relative small percent of imports, the CBE imposed an import priority list with the aim of focusing scarce foreign exchange on essential food commodities and inputs to manufactured goods. Traders, who are seen as the source of the luxury goods problem, were essentially excluded in 2003 from purchasing foreign exchange from the banks and are forced to use the higher priced parallel market that has emerged in the past several years. In March 2003, the CBE also required exporters and the tourist companies to sell 75 percent of their foreign exchange earnings to the banks. This was a significant reversal of a 1994 reform that allowed companies to retain all their foreign exchange if they so desired. To overcome resistance to this measure, the CBE is now guaranteeing these companies the foreign exchange for their needed imports even if it is not available at their banks.

While inputs for manufacturing and commercial agriculture are growing, essential food commodities for domestic consumption are still a significant component of imports.

Commodity exports have grown, and the growth in a number of non-traditional exports, such as fresh vegetables and fruits, is frequently pointed to as a sign of success in economic restructuring. However, overall, commodity export earnings still largely arise from traditional exports and much of this, such as extracted minerals and metals, remains in the public sector.

In January 2003, the GOE floated the Egyptian pound (LE) to let the market realign its price. However, given the tight foreign exchange market and the GOE's aversion to price increases

[35] See Annex II Table (2)

in the local market, the LE is still a managed currency, requiring restrictions and interventions to maintain some semblance of stability.

The Private Sector

The GDP data, discussed above, clearly evidence the increasing importance of the private sector. By Egyptian standards, many medium-sized firms have become large, and domestic producers are looking for export markets. Nevertheless, the private sector is still in its early stages of development, particularly *vis-à-vis* competing in the global economy. However, today, one is as likely to hear company management complain about the recession or other market conditions as about continued government interference or policy obstructions. Previously, the private sector was only preoccupied with eliminating the stifling effects of government rules, regulations and policies.

Distribution of Income

The transformation of Eastern Europe and the former Soviet Union resulted in a significant increase in the disparity of incomes and wealth. Before the transformation, private wealth was suppressed and the lower income majority was provided with a relatively uniform level of low quality goods and services. That the same process should occur in Egypt as policy changes shifted the economy from command to market should come as no surprise to GOE officials, the donor community and other knowledgeable observers of the economy. Egypt's economy was largely patterned after Eastern Europe, albeit without the depth and fervor of Eastern Europe's Marxist ideology. A core component of the economic reform program was the reduction of subsidies, raising the prices of many wage goods and basic services relative to the prices of goods typically consumed by the wealthy. In addition, the opening of the economy initially provided more opportunities to those who had capital or higher skill levels. In a World Bank study[36] by El-laithy, Lokshin and Banerji in 2003, the rapid growth of Egypt's economy during the second half of the 1990's tended to reduce poverty but slightly increase the disparity in the distribution of income.

[36] World Bank, Development Research Group, Poverty Team, Policy Research Working Paper 3068, Poverty and Economic Growth in Egypt 1995-2000, prepared by Heba El-laithy, Michael Lokshin and Arup Banerji, June, 2003.

APPENDIX IV: INCOME TAX REFORM PROGRAM

INCOME TAX REFORM PROGRAM

Submitted to:

Minister of Finance

and

U.S. Agency for International Development

Prepared by:

Barents Group LLC

September 2000

PROPOSED INCOME TAX REFORM PROGRAM

Background and Summary

The Global Income Tax Law enacted in 1993 represented an important first step in the modernization of the income tax structure in Egypt. However, much remains to be accomplished before the Egyptian income tax system conforms to the guiding principles of simplicity, equity, neutrality, and efficiency. While the Income Tax Law eliminated the schedular taxes and the overlapping general income tax that characterized prior Egyptian tax law, the resulting legislation retained many of the schedular characteristics of the old system. Therefore, the introduction of a true global income tax in the near future would be the cornerstone of direct tax reform.

In keeping with the major income tax reforms that have taken place around the world in the last two decades, a structurally sound Global Income Tax must be characterized by a broad tax base and low tax rates. The recommendations proposed in this program, both the structure of the global income tax and the administrative changes to implement it, have been specifically designed to accommodate the economic and administrative circumstances prevailing in Egypt today, and will result in increases in economic growth and improved productivity of tax collections.

The income tax reform recommended for Egypt, and described below, includes the following major features:

- Reduction of individual and corporation income tax rate;
- Substantial increase in the Family Burden Allowance;
- Phase-out of tax holidays;
- Elimination of special business deductions and exemptions;
- Strengthening of the system of penalties and enactment of interest charges for overdue tax liabilities.

Each of these major features of the recommended income tax reform is discussed below, followed by a concluding section that presents the estimated revenue and distributional effects of the program.

Objectives of Income Tax Reform

The proposed tax reform program for Egypt has been designed with five major objectives in mind:

- **Improved revenue productivity**. A basic objective of tax reform in Egypt must be to increase the revenue yield to the central government. Collections from income taxes should match actual liabilities under the law and should be more responsive to economic growth.
- **Fairness**. An objective of tax reform should be to ensure that the tax system is fair, imposing little or no income tax on the poor, treating those with equal incomes equally, and imposing a higher share of the tax burden on those with higher incomes. Fairness

also requires that those who owe taxes pay them in full and in a timely manner, issues that are particularly relevant in Egypt.

- **Neutrality and efficiency**. A tax system should be designed to interfere as little as possible with the decisions of businesses and individuals in response to market opportunities. In view of the large distortions in economic and financial decisions that result from the existing tax system in Egypt, this principle takes on particular importance as the country increases its reliance on market mechanisms to allocate resources and to promote economic growth.
- **Simplification**. A key principle underlying the design of a reformed tax and administration structure is simplicity. Simplification includes: designing a tax structure that is easily understood by both the taxpayers and the tax administration; eliminating duplicative taxes and burdensome methods of collection; removing many taxpayers from the tax rolls; and, to the extent possible, reducing the need for filing tax returns.
- **Effective administration**. To a large degree, achieving the above objectives will depend upon whether the tax is effectively administered. Revenue, fairness, neutrality, and simplification all require that taxes be assessed quickly and accurately and be paid promptly when due. Modernization of tax administration must be an essential element of a comprehensive tax reform program, particularly in the case of income taxes.

Discussion of Major Income Tax Reforms

Tax Rates

The income tax law currently includes four different tax structures depending on the sources of income:

1. The *tax on salaries and wages* is levied on income derived from employment. The tax structure has two marginal rates: 20 percent for taxable income up to LE50,000, and 32 percent for taxable income in excess of LE50,000.
2. The *tax on commercial and industrial profits* and the *tax on professional profits* are applied to unincorporated businesses. The tax schedule has four brackets, starting at a rate of 20 percent for taxable income up to LE2,500 and climbing to a top rate of 40 percent for taxable income in excess of LE16,000.
3. The *taxation of corporate income* includes the income of government enterprises and branches of foreign corporations as well as companies incorporated in Egypt. The tax rate is generally 40 percent, although a preferential rate of 32 percent applies to profits from exporting and industrial activities. Profits of oil exploration and production companies are taxed at a rate of 40.55 percent.
4. The *tax on mobile capital revenue* is levied at a rate of 32 percent on interest income, foreign source dividends and most payments to officers and directors.

Recommendations. An application of the objectives and criteria noted above leads one to a number of recommendations regarding the future income tax rate structure in Egypt:

- *Reduction of top marginal rates*: The following rate schedule would apply to all sources of income of individuals:

Taxable income less than LE 15,000	18 percent
Taxable income between LE 15,000 and LE 30,000	23 percent
Taxable income between LE 30,000 and LE 40,000	28 percent
Taxable income greater than LE 40,000	30 percent

This schedule, when combined with a generous family exemption amount (as outlined below), provides for substantial progressivity to the income tax system, and provides a revenue structure that is highly responsive to changes in incomes. For corporations a single rate of 30 percent is proposed, the same as the top rate applicable to individuals.

- *Uniform treatment of all corporate income.* Currently, there is a standard corporate income tax rate of 40 percent, and a preferential rate of 32 percent applicable to exporters and industrial activity. In accordance with the criteria for neutral taxation of all business income, preferential treatment for any type of business activity should not be allowed. Under the proposed broad-base, low-rate income tax system, currently tax-advantaged activities should continue to perform well without this unnecessary preference.

- *Uniform treatment of corporate and non-corporate business income.* The current alignment of top marginal rates applicable to corporate and unincorporated business income will be maintained.

- *Uniform treatment of non-corporate income*: Currently, different rate structures apply to wage and non-wage income. Consistent with several of the criteria outlined above, all sources of non-corporate income will be subject to the same four-rate structure outlined above.

- *Mobile capital revenue tax*: Currently, mobile capital income – essentially, various forms of portfolio income -- is taxed at a flat rate of 32 percent. The mobile capital revenue tax be eliminated, and all income currently subject to this tax will be taxed under normal income tax rules.

Family Burden Allowance

The increases in the FBA in 1994 and 1997 have helped to reduce the tax rolls and to introduce greater progressivity and equity into the tax system. It is recommended that the FBA amounts be further increased significantly. The table below shows the current FBA and the amounts proposed under the reform program.

	Existing	Proposed
Single taxpayers and working wives	2,000	3,000
Married with no children to support	2,500	3,500
Unmarried with children to support	2,500	3,500
Married with children to support	3,000	4,000

Personal and Employment-Related Deductions

Egyptian income tax law currently allows taxpayers to claim several personal deductions in calculating taxable income. A generally applied approach to tax reform is to keep personal deductions to a minimum in order to maintain a broad tax base that would permit low tax rates. By exchanging the loss of personal deductions for lower tax rates and higher family allowances, the average taxpayer will pay the same amount of tax, but the tax will be much easier to compute. Thus, the elimination of personal deductions contributes to improvements in the simplification of both tax administration and taxpayer compliance.

Recommendation: Personal deductions should be limited to social security and pension-related contributions and a deduction for life and health insurance premiums. All other employment-related deductions and allowances should be substituted for a single supplemental allowance for wage earners (in addition to the family burden allowance). The supplemental allowance for wage earners would be LE 5,000. The combined effect of the increase in the family burden allowance and the introduction of the supplemental allowance for wage earners will be to substantially increase the existing allowances for a married wage earner with children from LE 3,000 to LE 9,000.

Taxation of Business Income

Three basic principles of business taxation are that the tax rules should: (1) be neutral between different businesses; (2) accurately measure business income; and (3) be relatively simple for purposes of compliance and administration. Egypt, like many countries, falls short of what can reasonably be achieved with respect to each of these principles. The comprehensive income tax reform program attempts to improve the tax treatment of business income through several structural changes in the tax law. Each of these general areas of reform is outlined briefly below.

- *Interest Deduction*. A significant feature of the Egyptian tax system is the fact that most interest income is currently not subject to tax but most interest expense, at least for business purpose, is currently deductible in determining taxable income. This feature provides taxpayers with opportunities to engage in arbitrage transactions for the sole purpose of avoiding tax.

  Recommendation: In order to limit the opportunities for tax-arbitrage possible under the current tax system, Law 5/1998 will be strengthened to disallow interest expenses and other expenses associated with earning tax-exempt income.

- *Inter-Corporate Dividends*. Corporate-source income under current law is generally taxed only at the entity level and not to individual shareholders, thereby placing corporations on an equal basis with non-corporate enterprise where income is also taxed just once. However, dividends received by corporations bear a slight additional tax under current law in that 10 percent of such dividends are assumed to be the cost of holding stocks. Therefore, only 90 percent of dividends are deducted from corporate revenues in determining income subject to corporate tax, resulting in an effective tax rate on dividends of 4 percent for corporations subject to the standard tax rate. This additional tax on dividends received by corporations further reinforces the bias of the tax system in favor of debt in corporate financial structures.

Recommendation: To move towards greater neutrality with non-corporate activities and in recognition of the favorable tax treatment of debt, we propose that dividends received by corporations be fully exempt from the corporation income tax.

Tax Holidays

Although many arguments are made in support of investment incentives, there are an even larger number of more compelling arguments for avoiding their use:

- The extent to which tax incentives are effective in attracting new investment is far from clear. The empirical evidence for both developed and developing countries is mixed, but most evidence suggests that factors other than taxes play a much more important role in determining the level of investment and the gains in investment attributable to tax holidays are not great.
- Tax holidays cause many administrative problems and provide numerous opportunities for tax evasion as well as tax avoidance.
- In the absence of tax sparing agreements with other countries, tax holidays may result in an increase in tax liability of the corporation in its home country, negating, at least partially, any incentive effect.
- Market forces are more effective than government planners in deciding which investment opportunities are worth pursuing.

Recommendation: The elimination of investment incentives is a critical element of the movement toward a market-based economy. Consistent with this view, tax holidays should be phased-out over a five-year period. The phase-out rules would be the following:

- Projects starting at the beginning of the phase-out period would enjoy benefits for five years. For the first year, 100 percent of the firm's profits would be exempt. The exemption would be reduced to 80 percent of profits in the second year, 60 percent in the third year, 40 percent in the fourth year, and 20 percent in the fifth year. The firm would be fully taxable after the fifth year.
- Projects starting during the phase-out period would enjoy benefits, but the exempt portion of their profits would be reduced at a faster pace. For example, the proportion of exempt income for a project starting during the second-year of the phase-out would be 100 percent, 75 percent, 50 percent, and 25 percent for the four years remaining in the phase-out. Similarly the proportion of exempt income for a project beginning during the third year of the phase-out would be 100 percent, 67 percent, and 33 percent.

Other Special Business Preferences.

In addition to the investment-related reforms outlined above, there are two other significant business preferences in the current income tax code that should be repealed: a deduction for imputed rent on business structures and a deduction for paid in capital.

- *Deduction for imputed rent*. Under existing law, firms that own the property occupied by their business receive a special deduction for the imputed rental value of the premises. This deduction is in addition to deductions available for depreciation. This "double deduction" biases decisions toward investment in owner-occupied business structures and away from other types of investment that would be more productive for the Egyptian economy. Accordingly, this "second deduction" for owner-occupied business property should be eliminated.

- *Special allowance for paid-in capital.* Firms that are publicly listed on the Egyptian stock exchange receive a special income tax exemption equal to the product of their "paid-in" capital and the interest rate set by the Central Bank. This special exemption was intended to offset, at least in part, an income tax bias against new equity investment as a result of the exemption of interest income. However, this provision results in a significant erosion of the tax base and creates a tax system in which most income from debt and a large share of income from equity is untaxed, leaving labor income to bear a disproportionate portion of the total tax burden in the system.

  Recommendation: In order to broaden the tax base and implement significant reductions in tax rates, special preferences for corporations, including the allowance for paid-in capital, should be eliminated. The proposed low tax rate of 30 percent on corporations would substantially reduce the current system's bias against equity and would make it difficult to justify the retention of this special benefit.

Penalties and Interest

Voluntary compliance is the cornerstone of successful tax administration. An important economic factor that can positively affect compliance is the structure of penalties that applies to various forms of non-compliance. The system of penalties should reflect a consistent set of principles designed to fit the penalty to the offense, to permit universal application of the penalties by the tax authorities, and to encourage taxpayer compliance throughout the filing and payment process. Taxpayers who do not fulfill their legal obligations on a timely basis should also be subject to delay fines that reflect a positive, real rate of interest effective from the date that the payment was due.

In Egypt, penalties are applied to various forms of non-compliance with the income tax law, but many of these penalties are not adequate to promote voluntary compliance. Indeed, even if penalties are consistently applied, the absence of interest charges on overdue taxes provides and incentive for taxpayers to delay payment of their tax liabilities. As a result, only a limited portion of tax liability is collected in the year in which it is accrued. The majority of income tax collections are legally delayed for periods of five years or more, resulting in lower income tax revenues.

Reform of the penalty structure is therefore an essential component of comprehensive tax reform. Table 1 presents a summary of the proposed penalty system. The new structure of penalties would create significant, but reasonable, incentives for taxpayers to comply voluntarily with the law. Experience in other countries suggests that such penalties, if applied uniformly and consistently, can be effective in promoting compliance.

Table 1
Proposed Penalties

Interest on unpaid taxes	Interest is incurred from the due date of the tax declaration.
Failure to file a tax declaration	20% penalty with minimum of LE 300. In case of fraud, penalty of 100% and possible criminal prosecution.
Substantial unreported income	Where unreported income exceeds LE 10,000 for corporations and LE 2,000 for individuals, and the tax on the unreported income is more than 25% of total corrected tax liability, a penalty of 20% of the amount of tax on the unreported income is assessed.
Fraud	Monetary penalty of 100% of evaded tax in addition to criminal prosecution of serious cases as determined by the Tax Department and Office of the Public Prosecutor. Payment of the tax and penalty does not preclude criminal prosecution.
Failure to maintain books and records	Penalty of LE 3,000 increased to LE 10,000 for subsequent offense. Tax Department has authority to assess penalty without referral to Office of Public Prosecutor.
Failure to withhold or remit taxes.	15% of amount due if not paid within 30 days of the due date. Tax Department assesses penalty. If due to fraud, 100% penalty and criminal prosecution by the Office of Public Prosecutor
Assistance by accountants in filing false tax declarations	Where understated tax is more than 50% of the tax on the declaration and is due to action of an accountant, a penalty of 10% of the understated tax applies to the accountant. Tax Department has authority to assess penalty. If intention to evade taxes can be proven, criminal prosecution of the accountant, including loss of license, will apply.

Duplicative Taxes

The Egyptian tax system includes two levies, the stamp duty on government wages and salaries and the state financial development duty, that are effectively duplicative income taxes.

- *Stamp Duty on Government Wages and Salaries*. This stamp duty is applied to payment of government wages and salaries. It results in unnecessary complications to payroll administration and discriminates against government and public sector employees relative to private sector employees.
- *State Financial Development Duty.* The development duty consists of 16 distinct duties, one of which is a 2% tax on income. The existence of this "supplemental income tax" complicates the tax structure and costs of both taxpayer compliance and tax administration.

Recommendation: Following the reform program's objective of simplicity and transparency, these levies should be abolished so that all individual and corporate income is taxed only under the Global Income Tax Law.

Effects of the Proposed Program

The program of comprehensive income tax reform for Egypt is designed to broaden the tax base, reduce substantially income tax rates for individuals and businesses, and improve the overall compliance with the tax law. Such a comprehensive program will have major effects on Egyptian taxpayers and on the economy as a whole. This section presents estimates of the revenue effect of each significant component of the reform program, as well as the distributional impact the program will have on wage earners, and the effects on overall compliance.

Revenue Impact

The income tax reform program is designed to improve the structure of the income tax system while maintaining in the short-term the level of revenues raised from individuals and businesses compared to current law. The expected positive effects of the new tax system on economic growth and investment, combined with the improved compliance resulting from a more transparent tax law and from a more effective system of penalties also will result in an increase in the growth rate of tax revenues in the longer term.

The estimated revenue impact of the proposed income tax reform is presented in Table 2 for fiscal years 2001/02, 2002/03, and 2003/04. As reflected in the table, the reform program is effectively revenue neutral in the short-term. In the longer-term, as the phase-out of tax holidays is completed, the reform program will result in an increase in total income tax collections.

Table 2
Revenue Impact of Proposed Income Tax Reform[1]
(LE Millions)

	Fiscal Years: 01/02	02/03	03/04
	Net Change in Tax Collections		
Individual Income Taxes:			
Eliminate Exemptions and Deductions	475	970	1010
Eliminate Cost of Earning Income Deduction	1139	2324	2420
Broaden Base: Non-corportate Businesses[2]	12	20	32
Increase Family Burden Allowance	-1775	-3577	-3763
Lower Tax Rates	-123	-222	-319
Repeal Stamp Tax on Wages	-45	-91	-95
Repeal Development Duty	-26	-49	-63
Subtotal, Individual	**-342**	**-624**	**-777**
Corporate Income Taxes (Private Sector)			
Base-broadening Reforms	68	456	633
Lower Tax Rate to 30%	-31	-206	-286
Phase-out Tax Holidays	0	23	99
Repeal Development Duty	-11	-73	-102
Subtotal, Corporate	**26**	**199**	**344**
Reform of Penalties	**219**	**570**	**435**
TOTAL	**-96**	**145**	**2**

[1] Technical note: The revenue estimates of the individual components of the reform program (but not the total) are sensitive to the order in which the estimates are made.
[2] Estimated impact on unincorporated business income taxes of repealing imputed rent deduction and professional depreciation education

Distributional Impact

Of primary concern in the design of the tax reform program is the distribution by income class of the tax changes resulting from the program. For a variety of reasons, the impact of the program on wage earners is of special concern. First, wage earners constitute the bulk of the taxpayers in Egypt and should rightfully be entitled to many of the benefits of tax reform. Also, as a result of withholding of wage taxes at source, wage earners are the most compliant taxpayers in Egypt and accordingly deserve special attention.

Table 3 shows the distribution of tax changes for wage earners by income class upon enactment of proposed income tax reform program. As shown in the table, this program reduces taxes on wages and salaries by almost 12 percent for all wage earners.

The reduction in the income taxes of wage earners is progressively distributed. Taxpayers at the very bottom of the scale, those with taxable income less than LE 10,000, have their taxes eliminated or reduced significantly due in large part to significantly higher family burden allowances. Higher-income wage earners receive tax cuts of about 10 percent, and the tax liability of the taxpayers with the highest wages are increased. As a result, the new distribution of wage tax burden is more progressive than under current law.

In addition, as a result of the significant increase in the family allowance, more than 400,000 wage earners would be eliminated from the tax system. That is, the 400,000 wage earners with the lowest income in the system would no longer have to pay income tax, contributing to the progressivity of the system.

Table 3
Revenue Impact of Income Tax Reform
On Wage Earners
(percentage change)

Income Class (LE)	**Percentage Change in Liability**
0 < 2,500	0.0%
2,500 < 5,000	-100.0%
5,000 < 10,000	-93.3%
10,000 < 15,000	-34.1%
15,000 < 20,000	-13.9%
20,000 < 25,000	-5.1%
25,000 < 50,000	13.4%
50,000 and over	33.8%
TOTAL	**-10.4%**

Economic Effects

The proposed income tax reform can be expected to result in improved economic performance over the longer term for several reasons:

- The elimination of special exemptions and the reduction of tax rates will increase economic efficiency. The new system will minimize any interference with economic decisions of both individuals and businesses in response to market opportunities.
- The reform program creates a simpler and more transparent tax system that will facilitate decision-making by investors.
- The resulting growth in tax revenues in the longer-term will contribute to the continued financial and macroeconomic stability.

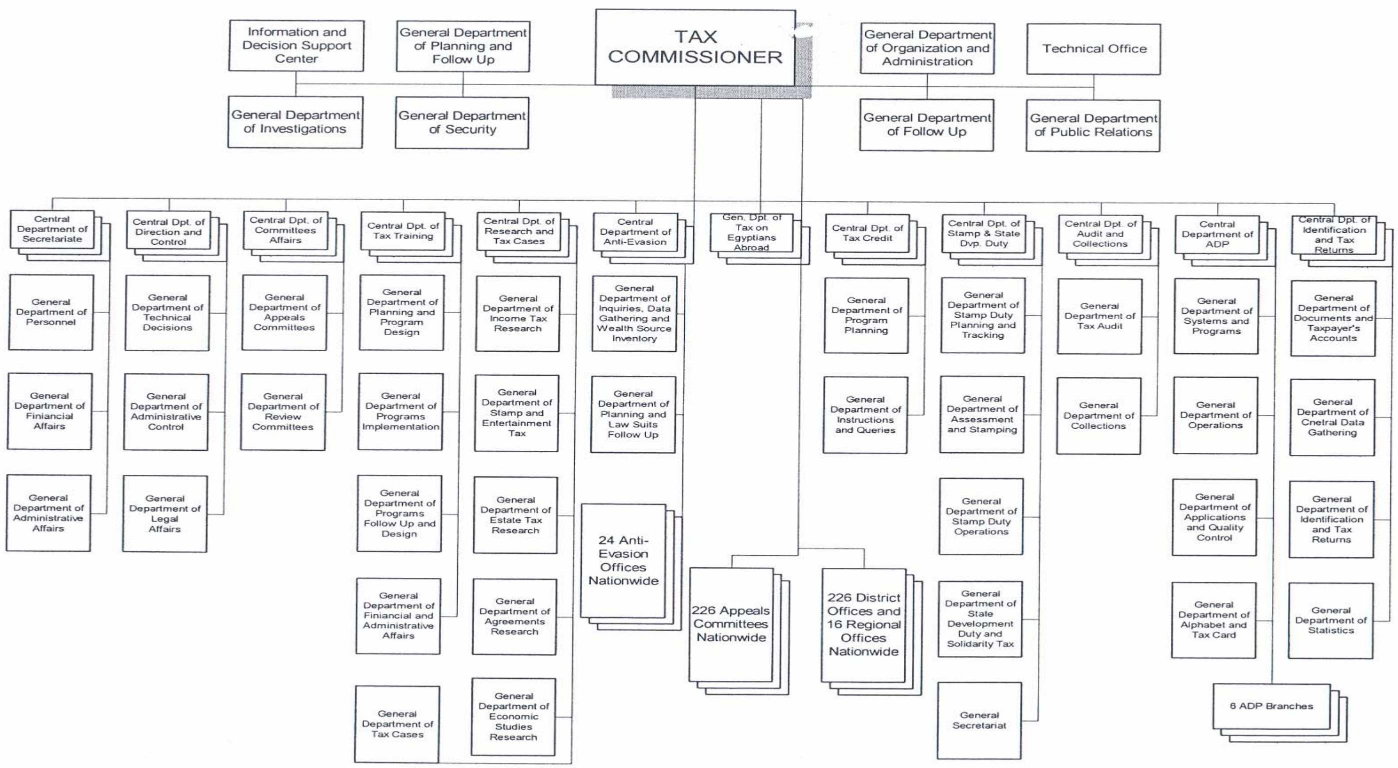
Administration and Compliance

The income tax reform program represents a fundamental first step in implementing in Egypt a self-assessment system based on voluntary compliance. In such a system, taxpayers' incentives for tax avoidance are minimized because the taxpaying public believes that those who do not comply will be punished, and that their own declaration of tax will not be punished by some arbitrary assessment by the tax authorities. This attitude creates a general belief that compliance with the tax laws is correct and necessary.

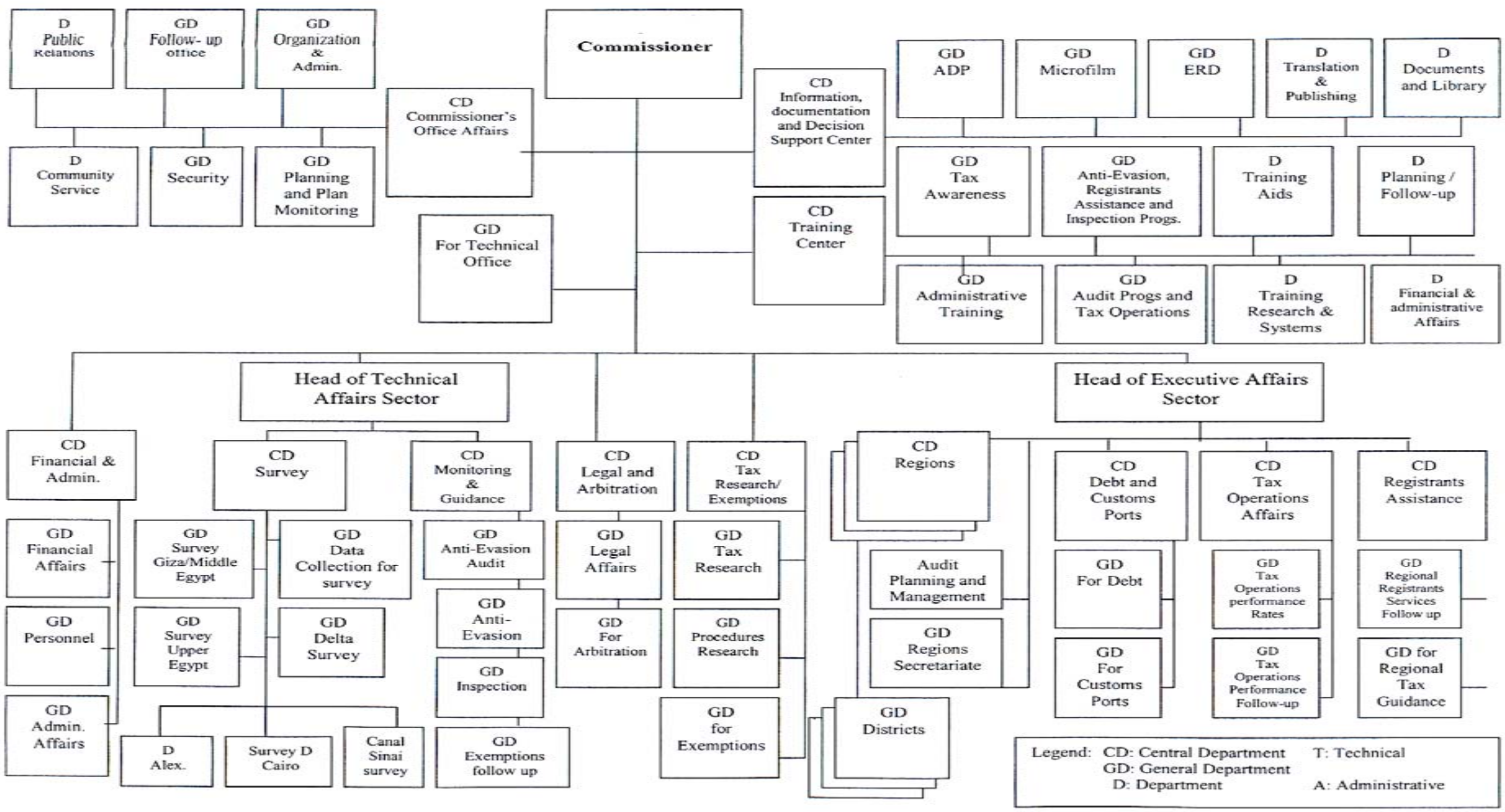
The proposed income tax reform program, by simplifying the tax law and strengthening the system of penalties, will contribute to the development of a culture of voluntary compliance in Egypt. These reforms will be combined with fundamental changes in tax administration directed at created a fully transparent processes and procedures for enforcing the tax laws.

APPENDIX V: ORGANIZATIONAL STRUCTURE OF TAX DEPARTMENTS

TAX DEPARTMENT (Income Tax)



Sales Tax Department



Model Customs and Tax Center