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Tax policy challenges in an era of political transition: The case of Egypt

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Abstract

Tax policy is normally formulated and implemented during politically stable periods. The collapse of the Soviet Union and Eastern bloc countries in the early 1990s have allowed researchers to study tax policy reform in transition economies with changing political and economic systems. This article aims to examine tax policy challenges in Egypt as a result of the revolution in 2011. Egypt has been chosen because of its importance in the Arab world and its interesting tax reform, including a rationalisation of tax incentives. It is found that Egypt has adopted a combination of counter-cyclical government expenditure policy and pro-cyclical tax policy in an era of political transition. This combination is interesting as it is well known that developed countries tend to employ counter-cyclical fiscal policy whereas developing countries tend to utilise pro-cyclical policy. It is proposed that the Egyptian government should consider modernising its tax administration and enhancing its anti-tax avoidance activities as an alternative to increasing tax rates in pursuing its pro-cyclical tax policy.

Keywords: Tax policy, Political transition, Business cycle, Economic efficiency, Equity

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1. INTRODUCTION

Theoretical and empirical studies of tax policy design and implementation are typically concerned with countries, mainly developed countries, having stable political and economic regimes. The collapse of the Soviet Union and the Eastern bloc countries in the early 1990s has allowed tax researchers to study tax policy reforms in the context of simultaneous political and economic transition (see, for example, Martinez-Vazquez & McNab, 2000). However, in some formerly central planned countries such as China and Vietnam, tax reforms have taken place within politically stable but economically evolving regimes. Twenty years after the dissolution of the Soviet Union, the Arab Spring has offered an interesting opportunity to examine tax policy in a reversal situation, that is, within a relatively stable economic system during political transition.

Taking advantage of this opportunity, this article intends to examine tax policy challenges in Egypt since the 2011 civil revolution. Egypt is chosen as a case study for three primary reasons. First, it is the most populous country in the Arab bloc with a significant cultural and political influence in North Africa, the Middle East and the Islamic world (Coleman, 2015). Second, it has, until recently, experienced three decades of reasonable political stability under the regime of former President Mubarak from 1981 to 2011 (Dahi, 2012). Third, Egypt has recently undertaken interesting tax reform measures, including a comprehensive rationalisation of tax incentives (see, for example, Abdellatif & Tran-Nam, 2016). It is thus insightful to consider such reforms in the context of Egypt's political transition.

Before proceeding further, it seems helpful to briefly review the recent political transition in Egypt. At the beginning of 2011, a number of Arab countries, such as Egypt and Tunisia, witnessed uprisings against long established political regimes. The young people were engines of the protests revealing their dissatisfaction of government policies, including lack of political freedom, cronyism, corruption and poverty (Khandelwal & Roitman, 2013). Because of problems of nepotism and ignorance, young people in those countries faced difficulties with finding jobs which have in turn created socio-economic tensions. In fact, income inequality has popularly been perceived to be one of the root causes of the revolution in Egypt (Kandil, 2011, p. 7).³

Young educated people in Egypt started using social media to express their disappointment of the regime and to call for changes. This motivated them to go out protesting, which resulted in the collapse of the Mubarak's regime and establishment of an interim government charged with implementing political changes to create a more democratic country. Another wave of political changes taking place in June 2013 led to new political regimes. Thus, since 2011, Egypt has suffered from political instability and the political transition process has been facing critical challenges (IMF, 2013a). Those challenges have mainly resulted from an inherited corrupted regime, resistance to changes from the previous regime by the business sector and interest groups, all of which have exacerbated political instability and prolonged the transition period.

³ Surprisingly, this perception was not supported by an analysis of Egyptian household survey data; see Verme et al., 2014 at 1.

The economic problems have also been exacerbated because of political changes, manifesting in rising unemployment rates since 2011 compared with the previous situation. Private investment has declined sharply and many businesses have been liquidated (Katulis, 2012). Economic slowdown has also been accompanied by a significant increase in the budget deficit as a result of increasing government expenditures while the tax revenue did not increase at the same rate to meet the additional spending (Morisse, 2013). Accordingly, the Egyptian economy was moving towards a new cycle of slowdown.

The increasing level of budget deficit and the reduction in economic growth rates as a result of declining economic activities during political transition raise the following research question, ‘what is the appropriate tax policy for socio-economic changes during political transition in Egypt?’ In order to answer this question, the present article will attempt to (i) review the scholarly works related to tax policy and business cycles, and the criteria of good tax policy, (ii) examine the Egyptian policy prior and post political changes, (iii) assess Egypt’s tax policy during political changes in terms of its relation with business cycle and norms for a good tax system, and (iv) provide specific policy recommendations to design appropriate tax policy during political changes.

The remainder of this article is structured as follows. Section 2 briefly reviews the literature that discusses the criteria of good tax policy and impact of political changes/transition on tax policy. Section 3 employs both theoretical and simple statistical analyses to examine the nature of tax policy and political changes in Egypt. In Section 4, the null hypothesis that ‘counter-cyclical tax policy is appropriate during political transition’⁴ is tested through assessing the relationship between tax policy and business cycle on the one hand and assessing the tax policy practices from the perspectives of good tax policy criteria on the other. Section 5 concludes.

2. LITERATURE REVIEW

2.1 An overview of tax policy

Tax policy has gained more importance, particularly in developing countries, since the early 1990s. This is mainly because many developing countries have launched their economic stabilisation and transition programs under the direction of international institutions, specifically the International Monetary Fund (IMF) and World Bank (Martinez–Vazquez & McNab, 2000). These programs often employ tax policy as a core element to tackle fiscal imbalance and accelerate economic growth rates. Accordingly, the majority of developing countries have carried out specific tax reform programs in order to achieve a number of objectives. In so doing, tax reform programs vary from one country to another because of differences among countries in terms of socioeconomic factors resulting in different tax reform approaches being employed (Thrisk, 1997).

Tax policy in developing countries faces a number of critical challenges, namely, (i) macroeconomic stabilisation, (ii) globalisation, (iii) economic development

⁴ The research question leads directly to the null hypothesis, which is based on the Keynesian approach which calls for counter-cyclical tax policy for macroeconomic stabilisation.

stimulation, and (iv) modernisation of tax administration (Vermeend et al., 2008). In an era of political changes, policymakers tend to be mostly concerned with economic stabilisation and economic growth. These two issues will be further considered below.

2.2 Tax policy and macroeconomic stabilisation

Macroeconomic stabilisation programs mainly focus on tackling a number of economy-wide issues, particularly unemployment, inflation and budget deficit. Tax policy, among other economic policies, is employed to overcome those issues (Montiel & Servén, 2006). However, a strong link can be easily identified between tax policy and budget deficits. In this regard, tax policy is being used to increase tax revenue through various techniques such as introducing new taxes, increasing tax rates, broadening tax bases, and changing the tax mix (Listokin, 2012).

Many developing countries had restructured their tax systems to increase tax revenue relative to GDP. This process resulted in changes in the tax mix through moving from easy to tax and collect into hard to tax and collect (Aizenman & Jinjarak, 2009). Consequently, foreign trade taxes have declined, especially as a percentage of total tax revenue, while Value Added Tax (VAT) and excise taxes have become more important (Keen & Simone, 2004). At the same time, income tax has been simplified and the marginal tax rates have been reduced. Those measures have led to significant results with regard to increasing tax revenues and consequently curbing budget deficits. Nevertheless, the ratios of total tax revenue to GDP in developing countries are still low in comparison with those of developed countries (Bird, 2008).

Tax policy and economic stabilisation in the short term reflected in the business cycle has been examined by several researchers including Talvi, Ernesto and Carlos (2005), Barro and Redlick (2011), and Vegh and Vuletin (2015). Those scholars carried out studies to identify the characteristics of tax policy in developed and developing countries. They found that fiscal policy, including tax policy, is counter-cyclical in developed countries and pro-cyclical in developing countries. Vegh and Vuletin (2015) developed a model for tax rate changes in 62 developing countries during 1960 to 2009 as a proxy of tax policy changes and they found that tax policy and government spending are both pro-cyclical. Accordingly they concluded that tax policy is pro-cyclical in developing countries.

2.3 Tax policy and economic development

Policymakers often use various tax policy means in order to encourage capital accumulation and consequently investment. This includes granting generous tax reliefs to domestic and foreign investors through various forms of tax incentives such as tax holidays, investment tax credits, reduced tax rates and special economic zones (Vann & Holland, 1998). However, the majority of developing countries tend to rely heavily on two types of tax incentives, namely, tax holidays and special economic zones. Nevertheless, many developing countries have recently come to the realisation that tax incentives are just one of the many determinants of investment including political stability, infrastructure, legal system, (OECD, 2007). As a result, many developing countries have either rationalised or abolished tax incentives (Bird, 2008). However, rationalisation or elimination of

tax incentives may not always be the optimal solution. Tax policymakers must find a proper way to assess the costs and benefits arising from tax incentives.

2.4 Criteria for assessing tax policy and political transition

Under the normative approach, researchers often use a small number of criteria to assess overall tax policy (Wagner, 1985). The monumental and seminal work of Adam Smith forms the core of current assessment criteria, which are equity, efficiency, certainty and flexibility (Coutinho, 2001). In an early study, Sneed (1965, p. 568) identified seven criteria for assessing income tax policy: (i) revenue adequacy, (ii) practicality, (iii) equity, (iv) stability, (v) reduced economic inequality, (vi) free market compatibility, and (vii) political order.

The efficiency of a tax system means that the tax system must achieve the desired objectives without creating unnecessary economic distortions. A distortion is said to occur when a tax system affects investment decisions, which in turn means that the tax system encourages some investments while discouraging others. In this respect Gravelle (1994, p. 29) defined efficiency as ‘minimizing distortions in the allocation of resources caused by taxes and on using the tax system to correct failures of private markets to allocate resources efficiently’. This concept draws attention to the role of the tax system in allocating resources (affecting the investor’s investment decision) and dealing with market failure issues (Sneed, 1965, p. 586). This also means the appropriate tax policy is important in fostering economic growth and increasing employment. These conditions help to identify the proper policy tools during an economic slowdown resulted from political changes.

In an era of political transition, the efficiency of a tax system is concerned with its ability to encourage private sector investments. Political instability negatively affects investment decisions, so policymakers need to design some measures within the tax system to mitigate the impact of political risks and to encourage investments. In this context, Carmignani (2003) examined the relationship between political stability and economy through assessing the impact of political stability on monetary and fiscal policies, and economic growth in general. He found that political instability negatively affects budget deficits and economic growth because of the uncertainty which affect the behaviour of economic agents.

The government is concerned with increasing public expenditures as a means to restore economic stability because of the increasing social needs. Increasing government expenditure requires an equivalent increase in government revenue through raising collected tax revenues or government borrowings. Increasing tax revenues poses a number of issues which are related to the adequacy of the tax system. In this context, a number of researchers, such as Mutascu et al. (2011) and Bohn (2003), have examined the impact of political stability on tax system in terms of tax revenue. They found a positive correlation between political stability and tax revenue collected in the long run.

An important criterion for assessing tax system is equity, which can be classified into ‘horizontal equity’ and ‘vertical equity’. Horizontal equity occurs when taxpayers with the same income bear the same tax burden. On the other hand, vertical equity refers to when taxpayers have more income they should pay more

income tax in both absolute and proportional terms.⁵ Vertical equity interpreted in this way implies progressive tax rate schedules under which the average tax rate rises as income increases (Chen, 2012). In this respect, the equity criterion can be used to impose higher tax rates on higher income groups as a tool to redistribute income. In the presence of political instability in Egypt, a progressive income tax system may be used to redistribute income from the rich to the poor to achieve greater equality.⁶

3. TAX POLICY AND ECONOMIC CHALLENGES DURING POLITICAL TRANSITION IN EGYPT

3.1 Economic challenges during political transition

3.1.1 Income inequality dilemma

The Egyptian revolt in 2011 provoked many researchers to investigate the factors leading to political uprisings. For example, Khalil (2011) examined the reasons behind the 25 January 2011 revolution and concluded that social inequality and lack of democracy were the main reasons for revolt. Other scholars have attributed the uprisings to the economic situation and social injustices (see, for example, Dahi, 2012). Dali (2012) reviewed the political development in Egypt from 1952 to 2011 and its economic consequences. The economic system developed after the 1952 revolution was known as the ‘authoritarian populist’ system under which the government was concerned to achieve social justice through a number of means such as: (i) implementing land agrarian to support peasants, (ii) employing workforce in urban communities in government and public sector, and (iii) giving the professionals the opportunity to be senior bureaucrats. So, regardless of the lack of democracy, the households’ needs were looked after. However, at the beginning of 1970s, the government started a new economic policy which was known as ‘economic openness policy’ to replace the authoritarian populist regime (Assaad et al., 2016).

New economic policies were adopted at the time to encourage foreign direct investment (FDI) as a tool to stimulate economic growth, which led to a diminished role of the middle income class and increasing role of businessmen in the community. Such a situation was further exacerbated after implementation of the structural adjustment program in the early 1990s, which was recommended by the IMF (Ansani & Daniele, 2012). The structural reform focused on three areas, namely, (i) deregulation, (ii) liberalisation, and (iii) privatisation. This has led to

⁵ Vertical equity is derived from Adam Smith’s principle of equity. It means those taxpayers who have a higher income have greater ability to pay and therefore should pay higher taxes. Adam Smith (1776, Book V, Part II) himself favoured proportional tax rates (‘The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities’). Over time, there is now a widely (but not universally) held view that those with a higher income not only should pay more taxes, but should pay a higher fraction of their income in taxes; see, for example, Stiglitz (2000, p. 470). The authors subscribe to the latter interpretation of vertical equity.

⁶ As discussed in the introductory section, important reasons for the Egyptian revolution on 25 January 2011 include income inequality and a lack of justice (Kandil, 2011, p.7). Thus, relatively more progressive government spending and income taxation may help to relieve inequality, or at least the perception of it.

the shrinking role of the government and an increasing role of the private sector in the economy. As a result of a lack of transparency and accountability, privatisation increased the level of corruption and income concentration.

As summarised in Table 1, growth rates of real GDP and real GDP per capita in Egypt have generally decreased over time, especially during the period just before the revolution. Table 1 also shows that the growth rate of GDP per capita has been considerably lower than that of GDP.

Table 1: Average Annual Growth Rates of GDP and GDP per Capita, Egypt

	1961–2010	1995–2011	2008–2011
Average annual GDP growth rates (%)	5.1	5	3.8
Average annual GDP per capita growth rate (%)	3	2.9	2

Source: Ansani & Daniele, 2012.

The income inequality issue addresses the capability of tax policymakers in dealing with the equity criterion within the Egyptian tax system. Hlasny and Verme (2013) conducted a study to measure the top income in order to identify the level of inequality based on three household income and expenditure surveys in Egypt using a number of different measures. They concluded that there is insufficient evidence about rising income inequality. Accordingly, policymakers should focus on stimulating economic growth to stabilise the economy and to create more jobs for unemployed people (Hlasny & Verme, 2013, p. 30). This study sheds light on the importance of increasing GDP growth rates as a tool to tackle a number of economic issues, particularly unemployment.

In a study of inequality in the southern Mediterranean region, including Egypt, El-laithy (2012, p. 7) found that the average loss in the Human Development Index (HDI) due to income inequality in Egypt is more than 25 per cent. This indicates there is scope for the tax system (income taxation) to reduce the level of income inequality in Egypt.

3.1.2 Stimulating economic growth

A critical consequence of political transition is slower economic growth and increasing unemployment rate because of the higher risk adherent to political instability (Ansani & Daniele, 2012, p. 2). In this context, Carmignani (2003) carried out an empirical study to assess the impact of political instability on economics through assessing its impact on growth, and fiscal and monetary policy. He found that political instability affects the degree of uncertainty of potential economic policies which in turn negatively impacts economic growth. This situation has been evident in Egypt since the start of political transition. The GDP growth rate went

down sharply from 5.1 per cent in 2009 to 2010 to 1.9 per cent in 2010 to 2011. Table 2 illustrates Egypt's GDP growth rates of real GDP from 2002 to 2014.

Table 2: Real GDP Growth Rate, Egypt, 2002 to 2014

Year	Real GDP growth rate (%)
2002–03	3.1
2003–04	4.2
2004–05	4.6
2005–06	6.9
2006–07	7.1
2007–08	7.2
2008–09	4.7
2009–10	5.1
2010–11	1.9
2011–12	2.2
2012–13	2.1
2013–14	2.1

Source: Central Bank of Egypt

The above table shows that the economy has been experiencing economic slowdown since the early 2010s. Another aspect related to economic consequences of political instability is unemployment level. Political changes have a negative impact on unemployment because it contracts the production level and consumption, the availability of new jobs is not sufficient to absorb new entrants to the labour market. Also many businesses were shutting down causing a further increase in the unemployment level. Consequently the unemployment rate rose during 2011 to 2014 in comparison with previous periods. This is summarised in Table 3.

Table 3: Labour Force (mil people) and Unemployment Rate (%), Egypt, 2000 to 2014

Year	Total labour force	Total employment	Total unemployment*	Unemployment rate (%)
2000–01	19.3	17.6	1.8	9.2
2001–02	19.9	17.9	2	10.2
2002–03	20.4	18.1	2.2	11
2003–04	20.9	18.7	2.2	10.3
2004–05	21.8	19.3	2.5	11.2
2005–06	22.9	20.4	2.5	10.6
2006–07	23.9	21.7	2.1	8.9
2007–08	24.7	22.5	2.1	8.7
2008–09	25.4	23.0	2.38	9.4
2009–10	26.2	23.8	2.35	9
2010–11	26.5	23.3	3.2	12.0
2011–12	27.0	23.6	3.4	12.7
2012–13	27.2	23.6	3.6	13.3
2013–14	27.6	23.9	3.7	13.3

Source: Central Bank of Egypt.

Political transition also impacts on private investment, which has declined sharply since the revolution. For example, FDI has significantly declined since 2011 to date as shown in Table 4.

Table 4: FDI Flow and Stock (in current million US\$), Egypt, 2009 to 2014

	2009	2010	2011	2012	2013	2014
FDI inward flow	6712	6386	-483	2798	4192	4783
FDI outward flow	571	1176	626	211	301	253
FDI inward stock	66 709	73 095	72 612	75 410	83 114	87 882
FDI outward stock	4273	5448	6074	6285	6586	6839

Source: United Nations Conference and Trade and Development (UNCTAD), 2016.

The above table shows that the FDI inward flow was negative in 2011 but improved in 2012 and subsequent years.

Egypt's situation during political transition indicates that tax policymaker face challenges from three economic aspects, namely, (i) stimulating economic growth, (ii) minimising unemployment rates, and (iii) stimulating private investment.

3.1.3 Budget deficit issue

Because of significant problems inherited from the previous political regime in terms of increasing poverty level and social injustice, the expectations of the majority of Egyptian people were culminated in terms of increasing salaries and better living standards. Such demands had manifested in the increasing number of protests and workers' strikes. Therefore, various interim governments that came to power were looking for ways to minimise the level of dissatisfaction through increasing government expenditures on wages and other social needs. Table 5 depicts the growth rates of government expenditure from 2001 to 2014.

Table 5: Government Expenditure (current million EGP), Egypt, 2001 to 2014

Year	Government expenditure	Growth rate (%)
2001–02	115 542	
2002–03	127 320	10.2
2003–04	145 988	14.7
2004–05	161 611	10.7
2005–06	207 811	28.6
2006–07	222 029	6.8
2007–08	282 290	27.1
2008–09	351 500	24.5
2009–10	365 987	4.1
2010–11	401 866	9.8
2011–12	470 992	17.2
2012–13	588 188	24.9
2013–14	701 514	19.2

Source: Central Bank of Egypt.

Since the revolution, government expenditure growth rates increased from 9.8 per cent in 2010 to 2011 to 17.2 per cent in 2011 to 2012 and then again to 24.9 per cent in 2012 to 2013. At the same time, government revenue has not increased at the same rate, as illustrated in Table 6.

Table 6: Government Revenue (current million EGP), Egypt, 2001 to 2014

Year	Total Revenue		Tax Revenue		Other Revenue	
	Amount	Growth rate (%)	Amount	Growth rate (%)	Amount	Growth rate (%)
2001–02	78 318		50 801		23 252	
2002–03	89 146	13.8	55 736	9.7	30 120	29.5
2003–04	101 881	14.3	67 147	20.5	29 683	-1.5
2004–05	110 864	8.8	75 759	12.8	32 252	8.7
2005–06	151 266	36.4	97 779	29.1	51 108	58.5
2006–07	180 215	19.1	114 326	16.9	62 003	21.3
2007–08	221 404	22.9	137 195	20.0	82 746	33.5
2008–09	282 505	27.6	163 222	19.0	11 1299	34.5
2009–10	268 114	-5.1	170 494	4.5	93 288	-16.2
2010–11	265 286	-1.1	192 072	12.7	70 927	-24.0
2011–12	303 622	14.5	207 410	8.0	86 109	21.4
2012–13	350 322	15.4	251 118	21.1	93 996	9.2
2013–14	456 788	30.4	260 289	3.7	100 643	7.1

Source: Central Bank of Egypt.

Table 6 shows that the government revenue increased in 2011 to 2012 and 2012 to 2013. However, government revenue growth rates were lower than the corresponding growth rates of government expenditure shown in Table 5. Consequently, budget deficits have increased not only in absolute values but also as a percentage of GDP (see Table 7 below).

Table 7: Budget Deficits as a Percentage of GDP, Egypt, 2001 to 2014

Year	Percentage
2001–02	9.8
2002–03	9.1
2003–04	9.1
2004–05	9.4
2005–06	9.2
2006–07	5.7
2007–08	6.8
2008–09	6.6
2009–10	8.1
2010–11	10.0
2011–12	10.9
2012–13	13.6
2013–14	12.3

Source: Central Bank of Egypt.

The above table shows that the budget deficit as a percentage of GDP in 2008 to 2009 was 6.6 per cent and it has been increasing steadily although it slightly declined to 12.3 per cent in the fiscal year 2013–14. Recently the IMF commented on the fiscal situation in Egypt as a result of high budget deficits and increasing level of finance. It stated that ‘countries with high levels of deficit and debt and large gross financing needs (including Egypt, Jordan, Morocco, and Pakistan) are exposed to shocks and swings in market sentiment and thus must take early decisive steps to safeguard against adverse debt dynamics and bolster credibility’ (IMF, 2013b).

The Egyptian government tends to rely heavily on domestic sources for funding budget deficits and this has a crowding out effect on private investments. With regard to tax policy, increasing budget deficit is related to the criterion of revenues adequacy, which will be used to assess the tax policies implemented since the 2011 revolt.

3.2 Tax policy in Egypt prior to 2011

In 1991, the Egyptian government, with the cooperation of international financial institutions, launched an economic stabilisation program. Accordingly, a new tax policy was needed to meet the program's requirements, which included minimising the severe budget deficit. A new sales tax was introduced by the *General Sales Tax Law No. 11 of 1991 (GSTL 1991)*. The revenue impact of this tax was considerable because the budget deficit to GDP ratio decreased substantially from 17.2 per cent in 1990–91 to 5.2 per cent in 1991 to 1992 and to 1.9 per cent in 2000 to 2001 (Abdellatif, 2011).

Also, in 1993, a significant amendment to the *Income Tax Law No. 157 of 1981 (ITL 1981)* was introduced. This amendment was known as the *Unified Income Tax (Global Income Tax) No. 187 of 1993* (Gersovitz et al., 1993). The fiscal imbalance was the main concern of tax policymakers, while the economic development objectives (for example, economic growth) were not addressed well in the 1990s tax policy (OECD, 2010).

Since the beginning of the new millennium, the Egyptian tax system has faced many new challenges relating to globalisation and the achievement of the millennium development agenda (United Nations, 2007). These objectives include accelerating economic growth, integrating national economy with the world economy, and achieving high rates of human development.

Because the tax legislation was outdated, it led to many economic distortions and constrained economic development. As a result, a new tax policy was launched in July 2004 (OECD, 2010). This policy focused on accelerating economic growth by encouraging private investment, broadening the tax base and modernising the tax administration. In order to achieve these objectives, a new income tax law was ratified in June 2005, the *Income Tax Law No. 91 of 2005 (ITL 2005)*. It repealed the *ITL 1981* and its amendments, and introduced new provisions in an attempt to cope with international taxation norms. Moreover, it also reduced the tax rates for both individuals (a progressive rate structure with a top rate of 20 per cent for individuals) and corporations (a flat rate of 20 per cent for corporations), and eliminated all tax incentives and development fees (OECD, 2007, p. 45–46).

Such tax policy was maintained until 2010 after which the political situation led to a number of tax reforms focusing on increasing tax revenue collection. Because of the increasing level of political unrest, the budget deficit has increased significantly (as discussed above), thus the government has been concerned with increasing tax revenue to control budget deficit blowouts. Since 2011, the government has introduced a number of tax reforms which are further elaborated in the following section.

3.3 Tax policy during political transition

The increasing social demands since the start of the political uprising has led to increasing government expenditures on social goods such as health and education. Such increases have not been accompanied by a similar increase in the government revenue which has forced the government to increase borrowing from banks through issuing treasury bills. This has consequently increased the amounts of interest payments (Shetta & Kamaly, 2014). The situation has manifested in the

rising ratio of budget deficit to GDP as shown in Table 7. Furthermore, a recent report by the IMF identified that the gross financing needs as a percentage of GDP for Egypt in 2013 and 2014 were 42.8 per cent and 39.9 per cent respectively.

Egypt has carried out a number of amendments to tax legislation because of the revenue need pressures. These include:

1. amendments to the *GSTL No. 11 of 1991* by *Law No. 4 of 2011* which includes, for example, waiving the surcharge tax on late filers of sales tax returns
2. amendments to the *GSTL No. 11 of 1991* by *Law No. 49 of 2011* which includes, for example, increasing the excise tax on tobacco
3. issuance of *Law No. 11 of 2012* which grants specific discount rates to taxpayers for paying their tax debts. The discounts range from 10 per cent to 25 per cent until the end of 2012, in order to encourage taxpayers to pay their tax debts and consequently increase the amount of tax revenue
4. issuance of *Presidential Decree No. 101 of 2012* which includes various amendments to a number of provisions in the *ITL No. 91 of 2005*. However such law was inactive until the issuance of *Law No. 13 of 2013*.
5. issuance of *Presidential Decree No. 102 of 2012* which amended *GSTL No. 11 of 1991*. This amendment includes increasing the tax rates on a number of goods and services.
6. *Law No. 13 of 2013* amends a number of provisions of *ITL 91 of 2005* which include:
 - a. adding a new tax bracket to individual income tax rates (annual income above EGP 250 000 will now be subject to 25 per cent tax rate instead of 20 per cent)
 - b. increasing the top marginal tax rate of legal entities other than individuals to 25 per cent instead of 20 per cent
 - c. imposing withholding tax on interest payments derived from treasury bills at 20 per cent and interest payments derived from government bonds at 32 per cent
 - d. introducing stricter measures to combat tax avoidance and tax evasion.

It is obvious that the amendments introduced by *Law No 13 of 2013* aimed to increase the tax revenues derived from individuals and legal persons. Nevertheless, these amendments also address a number of issues relating to equity and efficiency as discussed in the next section.

4. ASSESSING TAX POLICY DURING POLITICAL TRANSITION

4.1 Tax policy and business cycle

Discussions of economic challenges after the 25 January 2011 Revolution in Egypt have shown that there are a number of challenges facing the government, namely, (i) declining GDP growth rate, (ii) rising unemployment rate, and (iii) growing budget deficit. The first and the second macroeconomic issues require economic policy, particularly fiscal policy, to be employed in order to stimulate the economy. So government expenditure increase, as recommended by the Keynesian policy, is an important economic tool. A 1 per cent increase in government expenditure can, in principle, raise GDP by more than 1 per cent because of the government expenditure multiplier (Mankiw, 2007, p. 294).⁷

The second tool of fiscal policy to deal with economic downturn is tax rate cut in order to reduce the tax burden on business, which consequently promotes GDP growth, and lowers unemployment. This is referred to as 'expansionary tax policy' which is often prescribed under the Keynesian approach during economic downturn. Note that expansionary tax policy during economic downturn is an example of a counter-cyclical fiscal policy.

As mentioned previously, many scholars have identified that developing countries tend to use pro-cyclical fiscal policies which correlate positively with economic cycle. Increasing government expenditure during political changes is a counter-cyclical fiscal policy which is supposed to have a positive impact on the Egyptian economy during economic slowdown. In contrast, increasing tax rates as a means to raise tax revenue and curb the budget deficit, as discussed in Section 3.3, is a pro-cyclical fiscal policy. This tends to have a negative impact on private investments and, consequently, GDP growth rates and unemployment rates, especially after taking the tax multiplier effect into account. So, while Egypt's government expenditure policy has been counter-cyclical, its tax policy has been pro-cyclical during political changes. Therefore the null hypothesis is rejected and we accept the alternative hypothesis that Egypt has adopted a pro-cyclical tax policy during political transition.

4.2 Tax policy and economic efficiency

Since the 1990s, income tax reforms in Egypt have focused on creating a more efficient tax system mainly through cutting tax rates of individuals and corporations. This trend has been demonstrated clearly in the tax reform in 2005, in which the government implemented a lower tax rate schedule with a broader base tax system. The tax rate reduction in 2005 was significant since the top marginal tax rate for individuals decreased from 40 per cent to 20 per cent. Furthermore, the development fees imposed at 2 per cent were abolished. Such an approach is consistent with supply side taxation. It is argued that such a reform has improved a country's competitiveness and the efficiency of its tax system (OECD, 2010). Nevertheless, Egypt has not used the marginal effective tax rate to assess

⁷ The impact of government expenditure increase on GDP is indicated by government expenditure multiplier which measures how much GDP increases in response to an increase in government expenditure. In a simple macroeconomic model it is calculated by $\Delta Y / \Delta G = 1 / (1 - MPC)$ where ΔY refers to the change in GDP, ΔG to the change in government expenditure and MPC is the marginal propensity to consume.

the possible impact of raising tax rates on investments (OECD 2010). The current situation of increasing the marginal tax rate on individuals and legal persons from 20 per cent to 25 per cent can create economic distortions and contradicts the experiences of many developed countries which have adopted tax cut to stimulate the economy and create economic growth (Mankiw, 2007). Thus an increase in tax rates will have a negative impact on both investment and unemployment.

Tax revenue figures of fiscal years from 2010 to 2013 (Table 8 below) show that the private sector share of tax revenue has declined over the years. More specifically, the combined income tax revenue share of companies and individuals decreased from 60 per cent in 2010 to 2011 to only 46 per cent in 2012 to 2013. In more recent years, these combined shares were 49, 50 and 46 per cent in 2010 to 2011, 2011 to 2012 and 2012 to 2013 respectively. The decline of tax revenue derived from private investment is consistent with the decline in GDP growth rates because of political instability. So increasing the tax rate will negatively affect private investment and the economic growth rates, taking into account the impact of tax multiplier on economic activities.

In summary, a tax rate increase contradicts the economic efficiency principle and will have a negative impact on economic growth, private investment and employment. The increase in the growth rates of tax revenue to total revenues in 2013 to 2014 (see Table 6) appears to be attributable to the imposition of withholding tax on the interest payments on government treasury bills and government bonds which accounted for 7 per cent of income tax revenue in 2013 to 2014. Furthermore, it is known that the bulk of tax revenue is generated from government institutions, mainly through Egyptian General Authority Petroleum Cooperation, Suez Canal Authority and Central Bank of Egypt.

To have an efficient tax system, tax policymakers should focus on consumption tax, as occurred with the amendment to the *GSTL 1991*. Recently, the Egyptian parliament ratified the *Value Added Tax Law No. 67 of 2016* which abolished the *GSTL 1991*. The main reason for such tax reform is to increase tax revenue. It can also be claimed that such a reform is consistent to some extent with the criterion of economic efficiency, which tends to call for tax base broadening and a uniform tax rate.⁸

⁸ In terms of direct taxation, a broader tax base with uniform tax rate contributes to greater tax neutrality and increased economy-wide productivity (Freebairn, 2005). In terms of indirect taxation, the Ramsey optimal rule suggests that consumption tax should be imposed at a higher rate on more inelastic goods (Mankiw et al., 2009). This is impossible to do in practice since every commodity has a different elasticity for every consumer. Further, inelastic goods are more likely to be consumed by low-income households.

Table 8: Breakdown of Income Tax Revenue (million EGP), Egypt, 2001 to 2013

Year	Total income tax revenue	EGPC [*]		SCA ^{**}		CBE ^{***}		Other		Individuals	
		Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
2001-02	19 624	3562	18	3406	17	841	4	5.276	27	6539	33
2002-03	20 842	2564	12	4188	20	514	2	6.857	33	6719	32
2003-04	27 280	4771	17	6514	24	317	1	7.518	28	8160	30
2004-05	31 571	4030	13	7343	23	212	1	10.671	34	9315	30
2005-06	48 268	23 620	49	7321	15	0	0	7.946	16	9381	19
2006-07	58 535	25 380	43	9144	16	0	0	14.291	24	9720	17
2007-08	67 059	29 268	44	10 268	15	0	0	16.028	24	11 495	17
2008-09	79 073	34 135	43	10 391	13	0	0	20.263	26	14 284	18
2009-10	76 618	32 181	42	9443	12	0	0	18.591	24	16 403	21
2010-11	89 593	34 308	38	10 900	12	0	0	25.330	28	19 055	21
2011-12	91 245	34 075	37	11 800	13	0	0	23.674	26	21 696	24
2012-13	117 762	45 816	39	12 150	10	8 290	7	25.275	21	26 231	22

Source: Central Bank of Egypt.

Notes: * EGPC - Egyptian General Petroleum Cooperation

**SCA - Suez Canal Authority

***CBE - Central Bank of Egypt.

4.3 Tax policy and revenue adequacy

Revenue adequacy refers to the capability of the tax system to generate sufficient revenue to finance government expenditures. Assessing the tax policy in Egypt in terms of revenue adequacy reveals that the tax revenue has increased in fiscal years 2011 to 2012 and 2013 to 2014 as shown in Table 9 below.

Table 9: Tax Revenue as Share of Total Government Revenue, Egypt, 2001 to 2014

Year	Total revenue	Tax revenue	Tax revenue/Total revenue (%)
2001–02	78 318	50 801	65
2002–03	89 146	55 736	63
2003–04	101 881	67 147	66
2004–05	110 864	75 759	68
2005–06	151 266	97 779	65
2006–07	180 215	114 326	63
2007–08	221 404	137 195	62
2008–09	282 505	163 222	58
2009–10	268 114	170 494	64
2010–11	265 286	192 072	72
2011–12	303 622	207 410	68
2012–13	350 322	251 118	72
2013–14	456 788	260 289	57

Source: Central Bank of Egypt.

Such increase in tax revenue share is attributable to the following:

1. imposition of withholding tax on interest income derived from treasury bills and government bonds (see Table 8)
2. introduction of tax incentives in a form of specific discount rate for paying tax debts
3. increase in the sales tax rates on a number of goods and services.

The increase of tax revenue is evidence that the tax policy during the political instability focused on increasing tax revenue to meet increasing trend of government expenditure. However, the gap between government expenditure and government revenue has still remained high, and the budget deficit accounted for 13 per cent of GDP in 2012 to 2013. Consequently, the government should find another means to increase its revenues such as through improving enforcement measures and modernisation of tax administration. These measures entail fighting tax evasion and closing tax avoidance loopholes to increase the share of tax revenue to GDP above 14 per cent, as reported by the IMF (2013b).

4.4 Tax policy and equality

Achieving income equality and minimising social injustice were the main objectives of the 2011 revolution to which the tax system can significantly contribute and achieve through creating a tax system characterised by equity. Nevertheless, achieving equity implies the introduction of a progressive tax system which was almost abolished under Income Tax Law of 2005. This policy objective also contradicts the efficiency criterion. The interim government has increased the tax rates on individuals and other legal entities because of revenue needs, rather than concern for equality. However, this increase has a contracting impact on the economy and it negatively affects the economic growth in the short run. Accordingly, it is recommended that the government pursue the equity issue as a long term goal which can be achieved after restoring political stability.

5. SUMMARY AND RECOMMENDATIONS

This article has examined the challenges facing tax policymakers in Egypt since 2011 as a result of political changes which have led to economic slowdown. It reviews the fiscal policy in developed and developing countries during economic downturn and it is found that fiscal policy is counter-cyclical in developed countries and pro-cyclical in developing countries. Further, political changes and related economic consequences require assessing tax policy in terms of benchmarking criteria for a good tax system, including revenue adequacy, economic efficiency and stability, and equity.

An analysis of Egypt's tax law and budgetary data demonstrates that, in response to political changes, economic slowdown and increasing public expectations, Egypt has implemented a combination of expansionary (counter-cyclical) government spending policy and contractionary (pro-cyclical) tax policy. In particular, pro-cyclical or contractionary tax policy has been achieved mainly through increasing the tax rates on income and a number of goods and services, and a rationalisation of tax incentives.

The assessment of the implementation of tax policy in Egypt since 2011 has revealed several areas where improvements are feasible. First, the current tax policy practice has largely contradicted the criterion of economic efficiency since it ignores the current situation of economic stagnation and uncertainties related to the future of political instability which affect domestic investment in general and FDI in particular. Furthermore, the unemployment issue requires specific tax policy which encourages new business activities in order to lower the unemployment level.

Second, in terms of revenue adequacy, it is evident that various amendments of tax legislation have been steadily introduced in order to curb budget deficits. Thus, the government should pay more attention to the modernisation of tax administration and setting strengthened measures to curb tax evasion. This is because in raising tax revenue it is preferable to improve the efficiency of tax administration rather than to increase tax rates on income, good and services, which generally has a contractionary impact on the business cycle.

Third, it is extremely difficult at the moment for the Egyptian government to use its tax system to serve conflicting policy objectives: balanced budget, accelerated GDP growth, and reduced income inequality. The policy objectives of internal balance and faster economic growth should perhaps be temporarily delayed until political stability has been achieved via fiscal and social measures aimed at mitigating perceived or actual inequality.

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