


Shedding light on Egypt's shadow economy

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Context

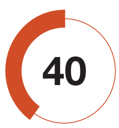
The size of the informal sector in any economy is a significant deterrent to inclusive economic growth. While it is true that millions of people depend on the informal economy to earn a living in developing countries, these informal activities deprive governments of potential tax revenues to fund essential services such as health and education. They are also a source of unfair competition for registered, tax paying businesses.

Egypt is no exception. According to some estimates , the country's informal sector accounts to 40% of GDP. A professor at Cairo University, estimates that the informal, or black economy employs approximately 10 million people in the country, with half of those jobs being year-round occupations. Around 85 percent of the small and medium-sized enterprises in the country are thought to be informal. Meanwhile, tax revenues in Egypt have fallen from a high of 25 percent of GDP in 1977 to 12.5 percent of GDP in 2015, according to World Bank data.

Government officials in Egypt face a number of challenges when trying to design policies to draw informal activities into the regulated economy. The most entrenched, is the widespread use of cash-based transactions – because there are no legal limits to their size (you can pay for a car or a house in cash, for example), and because people and businesses in the informal economy usually do not have access to banking services, relying on informal borrowing from relatives and acquaintances instead. The Federation of Egyptian Banks and the Federation of Egyptian Industries are worried about the unchecked growth of informal activities, with an estimate of 40 percent of cash-based transactions take place in the informal sector.

Egypt's large informal sector brings other problems too. Its very size distorts GDP and therefore policy making for the whole economy. Unregulated goods and services rarely comply with health and safety codes and legal redress for faulty goods or poor service is impossible to obtain. The informal sector also creates an unlevel playing field in various sectors of the Egyptian economy, which hurts economic growth in the long run. At the same time, it is important to note that the informal sector can act as a cushion in the event of economic downturn, while many small and micro enterprises find they have a wider scope of growth in the informal sector as barriers to entry are lower.

It is clear that the informal economy in Egypt will not be eradicated overnight. But what combination of policies might prove effective to reduce its size? What benefits might persuade informal businesses to register with the tax authorities, strengthening both the formal private sector and the government's tax revenues in concert?



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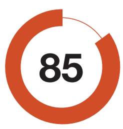

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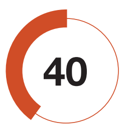

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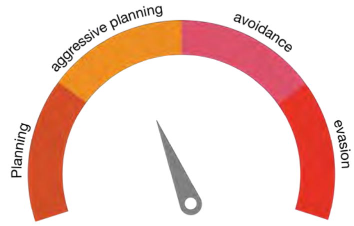
Making the link between taxes and public services

The Egyptian tax system is straightforward with regard to its tax treatment of income. Companies are subject to the corporate income tax ("CIT") at a flat rate of 22.5% with no tax credit. However, there are special rates for the Central Bank of Egypt, the Suez Canal, the Egyptian Petroleum Authority and Oil Exploration and Production companies. And, the natural persons are subject to personal income tax at progressive tax rates according to income brackets, with the first being tax exempt, the second taxed at 10% the third taxed at 15%, the forth at 20% and the fifth at 22.5%. The personal income tax includes tax credits for low income earners which should be taken into consideration when calculating the tax due for the concerned taxpayers. Natural persons who fall under the highest bracket, earning EGP 200,000 or higher per year are not eligible to any tax credit.

In understanding the attitude of Egyptians towards paying taxes, it is essential to clarify the difference between tax planning, tax evasion and tax avoidance Tax planning is legal; but aggressive tax planning is similar to tax avoidance because it seeks to exploit loopholes in the tax system without blatantly evading taxes. Informal businesses that are not registered with the tax authorities and registered firms that do not report tax revenues are non-compliant with the tax law and fall into the tax evasion category. Both tax avoidance in the formal economy and tax evasion in the informal economy hurt public finances and the government's ability to invest in development, infrastructure and essential services such as health, education and law and order.



What is most interesting about tax evasion in Egypt is how individuals rationalize the practice. Many people do not see the link between the taxes they pay and the public services they receive. A nationwide education campaign to explain how the tax system works and what it pays for might begin to lay the foundation for a tax paying culture in the country. The government has recently been trying to reduce the budget deficit by restructuring its tax scheme, but taxing may not be the only solution. Arguably, the key question the government should be asking is how to combat tax evasion. And here the answer does not lie in raising tax rates but in eradicating corruption.

Cooking the books and other forms of corruption

Tax evasion is aided by corruption, and this takes many forms in Egypt. Both external auditors and tax inspectors can facilitate tax evasion in exchange for 'under-the-table' monetary compensation . According to the World Bank's enterprise surveys, 68 percent of Egyptian companies say corruption acts as a major constraint on their activities. One-fifth of companies surveyed by the World Bank expected to pay a bribe to obtain an operating license; 27.9 percent reported being asked for a bribe to obtain a construction permit; 25 percent for a water connection; and 13 percent reported they were expected to bring gifts when meeting tax officials . Some companies 'cook the books' - an activity not exclusive to Egypt – which is usually done through under-reporting profits and/or inflating costs. Small and medium-sized enterprises (SMEs), an integral part of the Egyptian economy accounting for between 70 and 80 percent of GDP, are also vulnerable to unfair competition as quite a few large firms cook their books to masquerade as SMEs in order to take advantage of benefits such as subsidised credit (with loans bearing only 5 percent interest) that were meant to benefit smaller companies. The widespread use of cash makes it easier for large companies to under-report transactions.

In Egypt, there is no limit on cash transactions and this in turn facilitates the growth of the underground economy, tax evasion, money laundering, terrorism financing, drug and human trafficking, and many other illicit activities. Furthermore, the widespread use of cash limits the development of financial services and reinforces the financial exclusion of the most vulnerable sectors of the population. The fact that a large part of the population and many businesses are cut off from banking services is a major concern in Egypt. According to an IMF report based on the 2016 World Bank Enterprise Surveys, only 12 percent of Egyptian firms surveyed claimed to have access to financial instruments; 25 percent said access to finance was a significant constraint, that is, they suffered from financial exclusion.

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Promoting access to finance – the key to inclusive growth

A government's ability to promote financial inclusion depends on its capacity to invest in digitalisation. The need for digital readiness has clearly resonated with Egyptian authorities: in recent years, the Central Bank of Egypt has issued new regulations promoting mobile-based payments and initiated an expansion of financial inclusion by increasing the availability of banking services to the unbanked. Foremost among these efforts is President Abdel Fattah El Sisi's National Payment Council (NPC), which was set up to promote mobile-based payments and curb cash-based transactions in the informal sector. The NPC is a symbol of the government's determination to channel economic transactions through a regulated, electronic, bank-based system. One of the NPC's initiatives is the development of a national payment system with an overnight banking settlement mechanism for both individual and corporate banking customers. Another essential function of the NPC is to ensure that relevant government entities are synchronised with one another in order for the cashless transformation to be successful.

The Ministry of Finance is also clamping down on fraudulent accounting practices, including the issuance of 'bogus' receipts, by digitising the tax filing system and creating a sole platform for taxation activities. Although this initiative is both necessary and on the right track, the prevalence of cash-based payments may defeat the purpose of digitalisation. In other words, digitalisation will only be effective if policymakers impose an upper limit to cash transactions. The Ministry of Finance and the Central Bank of Egypt are working together to draft a new law that would set the limit at EGP 20,000 – an effort meant to bolster the transition towards a cashless economy. Furthermore, through the Government Fiscal Management Information System (GFMIS), any payment to government entities will have to be electronically processed through the banking system.

As for battling tax evasion, authorities have made filing tax returns online available this year for corporations. In 2019, filing returns will be compulsory for corporations and available for individuals. The Egyptian Tax Authority is aiming to establish a point-of-sale integration i.e. linking restaurants and schools with the authority through a common database through e-invoices. As a result of fighting tax evasion and the introduction of VAT in 2016, tax revenues for FY17-18 are targeted to reach 14.4% and 18% in 2022.

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The government's efforts to combat tax evasion have focused on SMEs and centered on developing a simplified tax regime tailored to their growth rather than maximising tax collection. The policy is geared towards delivering benefits to SMEs that are tax compliant, including tax credits, access to finance, and discounts on utility bills. SMEs are classified into different categories, in an effort to facilitate tax procedures, and taxed based on the presumptive tax rate, rather than VAT and income taxes, in order to reduce the effective tax rate and encourage compliance. Other benefits include making technology such as smartphones available to SMEs at low cost. The smart phones come with mobile-banking applications and are intended to create momentum towards digitising the Egyptian economy.

Despite the government's efforts, there are some cultural aspects that are hindering economic progress with corruption being most pronounced. Egypt is a member of the Global Forum on Transparency and Exchange of Information and must achieve certain standards by the third quarter of 2019 –including providing tax authorities with access to bank accounts. This would require a closer relationship between tax authorities and banks, facilitated through an integrated digital database that would significantly increase the ability of tax inspectors to inspect banking transactions to detect fraud and tax evasion. But in order to effectively defeat corruption, it is also essential for the government to eliminate regulations that facilitate corrupt practices – for example, a tax rule that allows up to 7 percent of general and administrative costs to be accredited to 'tips'. This rule is often used to mask the payment of bribes. Furthermore, Egypt should learn from the mistakes of other governments that have tried to eliminate cash from the economy too quickly. India removed 86% of its currency from circulation in November 2016 - a cold-turkey method that has yet to be proven effective.

Egypt Vision 2030

As part of its vision for 2030, Egypt must coordinate its digitalisation efforts among different government entities. Bringing informal firms and services into the formal economy will help fight corruption, tax evasion, and financial exclusion. Egypt has already laid out the groundwork for this initiative; however, it must continue to dedicate resources towards digitalisation in order to truly transform and develop into one of the region's leading nations.

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