The Impact of the Floating Egyptian Pound on Tax Revenues in Egypt

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Abstract:

This study aimed to examine the impact of the flotation of the Egyptian pound on tax revenues in Egypt, both before and after the flotation. The authors of this study hope to shed light on the significant effects of floating the Egyptian pound on Egyptian tax revenues and to determine whether this flotation. This period is considered important because it witnessed the beginning of several other significant events that affected Egyptian tax revenues. Some view these results negatively, while others see them positively; and the real effects will appear in the near term and become clear in the long term, as the positive effects only manifest when Egyptian tax revenues develop in the long term.

1. Introduction

There has been little work on this issue, and no research we are aware of on the specific case of Egypt. However, the links between devaluations, trade balances, and tax revenues are complex and this paper aims to shed some light on them and provides some background on the devaluation and an overview of tax revenues in Egypt and gives a brief overview of the devaluation itself, explaining why it was done and summarizing evidence on its effects and outlines the main channels through which a devaluation can affect tax revenues, concentrating on the effects on revenues from trade taxes and the Value Added Tax. These are the two indirect taxes which together account for around two-thirds of total tax revenues in Egypt. Effects on direct taxes and on revenues from natural resources are also considered.

Finally provides an overview of tax revenues in Egypt, beginning with some descriptive evidence and then discussing trends and recent developments. and aims to put the analysis of the effects of the devaluation into the context of a general overview of fiscal developments in Egypt.

1.1 Background of the Floating Egyptian Pound

The first part of the essay discusses the background of the Egyptian currency and the developments in the exchange rate regime in the recent past. The Egyptian pound (EGP) was first brought into circulation in November 1885. The pound was equal to 12.377 grams of pure silver and it replaced the Egyptian piastre as the chief unit of currency. The piastre continued to circulate with 1 piastre = 1/10 of a pound. However, in the recent past, from the period of 1962 to 1989, the Egyptian Pound was linked to a currency basket as well as directly to the US dollar. Fixed rates and multiple currency practice were adopted in this period and it is often believed that the black market was the exchange rate that most trade and investment were based on. The precise rate was delinked and devalued on a number of occasions and attempts to reform the system were not sustained. Due to widening the gap between the parallel market and official rates, in the face of diminishing official reserves and growing balance of payments problems, investors and traders became disillusioned with the system.

A further devaluation was then postponed, resulting in an eventual debt rescheduling with the Paris Club and a program with the IMF. (1) Step by step implementation of the key elements of the IMF reform program was to be supported by a devaluation in order to establish a realistic exchange rate as a reform anchor. In 2000, the law was changed to unify the two rates and though the currency remained pegged, the exchange rate system had become a form of crawling peg. This peg was then abandoned in 2003 and the EGP was instead pegged to a single currency, the USD. Although the dollar's depreciation created problems, it was the episodes of appreciation against the dollar on the back of large capital inflows that forced a series of official unilateral interventions in a bid to maintain Egypt's exchange rate competitiveness. This inevitably gave rise to an overvalued real effective exchange rate. The recent floatation is the first time the pound has not been set to a fixed rate in the history of Egypt's currency regime. Given that it was somewhat of an overdetermined system over the past years, the floatation represents a move to a regime where supply and demand of forex is the chief determinant of the EGP's value. (2)

1.2 Importance of Tax Revenues in Egypt

A higher tax revenue reduces the need to borrow if the government chooses to spend more and it can also decrease a budget deficit. With its recent $12 billion loan this past November and looking to borrow an additional $3 billion, this is something Egypt has been doing frequently. No one can predict the future and whether or not Egypt will have to ever take out another loan but with an increase in tax revenue it is less likely to occur. This past December Egypt's Supreme Council for

Customs and Tax announced an increase of 1.5-2 LE tax on cigarettes which will earn an additional 1.5 billion LE for the Egyptian Tax Administration. An increase in tax duty is not something people are happy about, especially since it will include a price increase for cigarettes but this still can be a good thing for Egypt. (3) With a more volatile pound currency and the possibility of import substitution and export promotion, tax on goods and services will increase more. This may be looked at as a harmful way to increase tax revenue but for the long run it is a good thing. A possible study on the impact of the floating pound on tax revenues may show that more imported goods through increasing tax will mean more revenue and this can compensate for the cigarette tax which is a non-essential domestic product. With many different ways to tax, it is up to the government to make the best decisions. With an increase in tax revenue, net foreign wealth from increased investments and an IBRD Structural Adjustment Loan will increase significantly. (4)

With decreases in top oil revenues and an overall decline in economic activity, Egypt turned to taxes on goods and services as a replacement for its oil-based revenue. With oil revenue being something, Egypt could always rely on due to its high demand from many different countries, it was an easy source of cash flow for the government and was at a constant rate flowing in. This being said, reliance on oil revenues was too high and as I mentioned before, top oil revenues have led to a decrease in overall government earnings. Now with the change in tax policy towards goods and services, a more volatile currency allows for an increase in export growth. (5)

Today's governments rely heavily on tax revenues as a source of income. The International Monetary Fund (IMF) stated, "Tax policy is an essential element of overall economic policy...it is an important instrument for attaining short-term and long-term economic goals such as price stability, high employment, and sustainable economic growth." This is especially true for Egypt at this time. Going back to early 1991, Egypt's tax-to-GDP ratio was a fairly low number of 10.7% and has been on the rise ever since, the highest point being in 2008 at 17.7%. Although this ratio has only increased little by little, it is still a big move for Egypt. (6)

"Navigating Currency Devaluation: Egypt's Floating Pound"

In the wake of the Central Bank of Egypt's decision to float the Egyptian pound on October 27, the currency experienced a marked devaluation against the dollar, coinciding with Egypt securing a three-billion-dollar loan from the International Monetary Fund (IMF). Therefore, the researcher attempts to shed light on the rationale behind this loan and its implications for everyday citizens.

Egypt grapples with a multitude of financial commitments, such as public sector wages and subsidies, that outstrip its limited revenue streams. To offset this deficit, the government turned to the IMF for financial assistance.

Currency floating involves relinquishing control to market forces, allowing supply and demand dynamics to dictate its value. Consequently, the value of a floating currency fluctuates in response to factors like foreign currency reserves and market conditions. (7)

Regarding the short-term and long-term impact of an IMF loan on the economy, immediate funds are injected to bridge the financing gap in the short term. However, in the long term, the loan adds to Egypt's financial obligations.

The imposition of import restrictions aimed to alleviate mounting financial pressures on the government budget, particularly concerning foreign currency expenditures, while simultaneously safeguarding and bolstering domestic industries.

Inflation, measured through the consumer price index, reflects the erosion of purchasing power due to escalating prices of goods over time.

The Russia-Ukraine conflict bears direct and indirect consequences for Egypt. As a significant importer of wheat, Egypt feels the direct impact of disruptions in wheat production and export. Indirectly, the conflict contributes to a global economic slowdown, reducing demand for goods and affecting trade via the Suez Canal. Additionally, it impacts tourism revenue and job creation, thereby diminishing foreign currency inflows. (10)

Predicting the future for ordinary Egyptians amidst declining purchasing power and escalating inflation is challenging. The visible decline in their standard of living is evidenced by prioritizing necessities over luxuries, signaling a significant impact on their overall quality of life. (11)

Reasons for Floating the Pound in Egypt

1. Economic Challenges Faced by Egypt

After the revolution in 2011, Egypt has been facing economic challenges such as high inflation rate, declining foreign reserves, and increasing budget deficit. Before the pound was floated on November 2016, the Central Bank of Egypt was using the foreign reserves to keep the value of the pound stable. Egypt was trying to exit the pegged exchange rate system in 2003-2005. At that time, due to pressure from the IMF, Egypt implemented a reform program aiming to increase growth and create jobs by adopting a more flexible exchange rate system to boost exports. However, in October 2004, due to the fear of sharp depreciation of the pound, the CBE went back to the pegged exchange rate system. (8) The pegged rate was negatively affecting the economy due to the strong USD and speculative movements by traders. These elements resulted in an overvalued EGP during 2004-2016. The Central Bank was always trying to maintain a strong pound relative to the USD. Before the revolution in 2011, the pound was trading at a rate of 5.6, and the pound was strongest at the end of 2011, trading at a high of 5.8. However, the pound immediately started to depreciate after the revolution due to political instability. (12)

By utilizing the foreign reserves to maintain the value of the pound, it has remained overvalued. The effects of trying to maintain a strong pound can be seen in the Real Effective Exchange rate. By deflating the Nominal Effective Exchange Rate by the Ratio of Domestic to Foreign Price, REER shows the relative value of a currency compared to other countries. An overvalue of 100 indicates an overvalue, while under 100 indicates undervalue. Due to the behavior of maintaining a strong pound, the REER of the pound has been over 100 compared to a basket of currencies. Hence, it has become evident that the pound was overvalued in the exchange market.

The overvalued pound was inflating the loss of competitiveness for exports. Since Egypt is a country relied mainly on agriculture, textiles, and other goods in the export market to produce income for the country, the overvalued pound was crippling exports as it is cost-effective for importers to buy foreign currency to buy Egyptian products. This resulted in the foreign currency reserves being filled with purchases of cheap foreign currency, hence the strong USD. The declining foreign reserves also contributed to the devaluation of the pound. An example is in 2012 when the CBE was offering to buy USD to support the pound at its current rate. However, due to the lack of foreign currency, no such transactions happened. This showed that there was no demand to sell the foreign currency. As such, whether it was due to an increase in imports or capital flight, no official statement was ever made. (13)

1.1 High Inflation Rate

In the recent past, Egypt has been faced with inflation rates as high as 33%, something very difficult to control. The inflation rate has been fueled greatly by the subsidies on various goods. In layman's terms, if there is a subsidy on bread, the price of bread rises in the free market as producers know the government has given them money to keep the price down. The demand for the money is so high, due to interest rates and exchange rate expectations being higher. Egypt has a flexible exchange rate. In order to understand the inflation rate, it is good to use the quantity theory of money. (14)

This shows the relationship between the money supply and level of prices. Although this has been an ongoing problem for Egypt, the inflation rate and associated problems it has recently faced have not been the reason for floating the pound. An inflation rate as high as 30% would historically be a reason for a country to depreciate their currency as the price of exports would be relatively cheaper, and imported goods more expensive so AD would fall as people switched to domestic goods. However, Egypt has not been in a position to increase the price of exports, as can be seen by the trade balance. This is due to the comparative lack of demand for Egyptian goods. Many prices of goods have doubled in recent years and this has been another contributor to the inflation. Due to the instantaneous nature of imported goods, prices have increased quickly. This has made consumers substitute more within imports and away from Egyptian goods. The price and income elasticities of demand mean that the quantity of imports and the quantity of goods substituted are increasing. (15)

This, coupled with exchange rate expectations, has meant that there has been speculative demand for foreign currency. This is where the MPC would sell sterling expecting to buy it back in the future at a lower rate. This shifts AD to the left, raises the price level, and increases inflation. Overall, Egypt's inflation rates have been complex and due to the different factors and elasticities, difficult to control. High inflation rates and the flotation of the pound have not been directly caused, but have created a platform for many of the issues Egypt has faced and the reason behind the flotation.

1.2 Declining Foreign Reserves

The decline in foreign reserves can be a very sensitive and important economic indicator, and in the case of Egypt, the decline played as an important sign to the necessity of further economic reform. In 2010, Egypt's foreign reserves were at its peak, $36 billion USD, however, this would begin to change due to the global movement in capital triggered by the 2011 Arab Spring (affect on Economy). Investment and tourism in Egypt began to decline, which respectively saw a decline in direct and portfolio investment as well as a decline in foreign exchange inflows and government revenue. This is important because the majority of foreign exchange reserves are held by the central bank or monetary authorities and are often used to back the national currency and to pay off foreign debt; a decrease in these reserves will affect the exchange rate, thereby devaluing the currency which was the case in Egypt. This in turn would trigger an increased demand for foreign currency, putting more pressure on the exchange rate. (16)

This would be hurtful for Egypt as it raised the price of imported goods with the devaluation of the Egyptian pound. This would be damaging as Egypt imports a large amount of its goods and the more expensive foreign exchange rate would mean there are increasing trade balance deficits as it indirectly affects the budget deficit. This all culminated in a highly speculative environment in which there was an anticipated further devaluation of the currency and therefore more capital flight. Devaluation speculation and capital flight are indications of investors and residents losing confidence in their country's economic and political environment. Due to these adverse effects on exchange and trade, the government did attempt to use the reserves to try and stop the devaluation by the central bank increasing dollar sales to maintain the exchange rate. However, the selling of the EGP would lose its backing effectively as it led to an increase in the balance of payments as well as caused a drain on the foreign reserves it hoped to protect. This whole decline in reserves and its effect on the price of imports and unsustainable monetary policy can be outlined through the IS-LM model. (17)

1.3 Increasing Budget Deficit

Just to add to the confusion, navigation through the exchange rate by the Central Bank of Egypt had involvement of a crawling peg exchange rate system altering both the upper and lower limits of the exchange rate. Downfall in the terms of trade at many points in the early 90s had adverse effects on the exchange rate, and with the nominal rate set higher than the real rate, it was simply aggravating the situation by misrepresenting the value of the Egyptian Pound. This was because the Central Bank's determination to maintain a strong exchange rate for lower import prices had effects putting pressure on a balance of payments which leads on to the following section. (18)

The losers would always be those who had hard currency debts as the government felt compelled to repeatedly renege on promises to float the exchange rate whereby the cost of servicing the debt in E£ would decrease. The foreign debt situation in Egypt has improved significantly since 2004. However, this was always a cause of concern at its worst, violating principles of national sovereignty by causing the freezing of foreign currency accounts held by multinational companies that would be forced to take their money out of Egypt, resulting in a decrease in foreign direct investment in fear of further capital flight. (19)

Tax Revenues in Egypt

The government budget deficit represents a serious problem in the Egyptian economy. During the period of 1980 to 1987, the average budget deficit was 15% of GDP. Reducing the budget deficit and thus reducing the fiscal gap has been a primary concern of economic policy. One major method to decrease the budget deficit is to increase tax revenues. Tax revenues have been relatively low in Egypt. The average tax revenue to GDP ratio in Egypt from 1973 to 1987 was 18.2%, compared to an average of 28.6% for the rest of the sample of low middle-income countries. The total government revenue to GDP was 23.5%, compared to an average of 32.4% for the rest of the sample. The tax burden in Egypt is relatively light. (20)

This is especially true for direct taxes. In the rest of the sample, government revenues were divided approximately evenly between direct and indirect taxes. In Egypt, 53% of government revenue came from direct taxes and 47% came from indirect taxes. The tax burden approximated by the ratio of tax revenue to GDP is lower in Egypt than in the comparison countries mainly because of low receipts from the natural resource sector. In particular, the ratio of income tax revenue to GDP is the lowest in the world. Tax incidence is an important concept when analyzing the equity and efficiency of a tax system. The incidence of a tax is determined by the relative elasticities of supply and demand of the goods being taxed. This is important because in developing countries, the supply of various factors of production is likely to be more elastic than in developed countries. (21)

This is especially true in Egypt due to the surplus of unskilled labor. The low-income groups in developing countries are also likely to spend a large proportion of their income on goods that have highly elastic demand. So, for a tax to be progressive, it must be imposed on goods and factors of production with low elasticities of supply and demand. It is widely accepted that Egypt has had great difficulty in establishing a progressive tax system and that the tax burden has been regressive on both efficiency and equity grounds. This will be discussed further when examining specific taxes in Egypt. (22)

1.1. Importance of tax revenues

It is widely agreed that tax revenues are the lifeblood of national development. This raises the questions of "how and why?" Tax revenues affect economic growth directly through financing of development projects. The objective of tax-money utilization is to indirectly impact the community by providing better living standards and promoting social welfare. This can be achieved by increasing economic growth. By nature, certain tax measures may be taken to improve the distribution of income in a country.

This also forms the basis of equity in tax, and the money raised can then be used in providing doctors and education facilities to lower income groups. The role of tax revenues is especially critical in developing countries where it provides the bulk of government revenue. It is thus no surprise that the taxation systems in these countries are crucial determinants of their economic and political developments. This is due to the fact that government revenue is a necessary condition for positive change; however, it is not sufficient by itself. (23)

With the burden of payroll taxes on employers and the fact that they are seen as socially unjust, they are in gradual decline, as seen by the introduction of a cap on the employers' tax rate. Social contributions taxes have seen a rapid increase during the 1990s with the introduction of a new health insurance tax, the tax rates for different funds being unified, and reforms to stamp out evasion of payments. This has resulted in it becoming the main source of revenue for taxes on the workforce. (24)

1.2 Taxes on Payroll and Workforce

Revenue from taxes on property is very low in comparison to its potential yield, mainly due to the fact that current property values for tax purposes are well below market values. The exception to this is the agricultural land tax, which is the only tax of its kind where the tax base values were not changed for over 50 years due to the fact that it was introduced more than 70 years ago. (25)

The introduction of the flat tax rate of 20% and increases in the personal income tax free allowance have reduced the number of people paying income tax and increased net disposable income. Tax evasion is still a major issue, but there is evidence that people are more willing to pay tax because of improvements in public services, despite not having an effect on the proportion of people paying tax. (26)

1.2.1 Taxes on Income and Profits

An amount of tax may vary to prefer different sources of money. To some, the biggest source of money will have the most taxes, and the smaller source of money will have fewer taxes. Taxes on income and profits in Egypt take a big part of the national income. This is why Egyptians take it seriously when any tax issues come up because they wouldn't want to be overtaxed to compensate for the earnings they got. The increase in collection by 15-20% per annum gives an overview of the society who has awareness towards taxation.

The effect of so many tax issues is that it makes Egyptian people learn more about how to count the amount of income and the deductions. It can be seen from the people who are going to ask for more jobs because of the tax effect of the reductions in salary, bonuses, and profit, that they understand the ways taxes should be imposed. Any person who still receives a high amount of money usually will have another job like becoming a private tutor or a part-time lecturer at a college, who still have a high wage. In a more serious case, there are people who are going to quickly cross the line by evading tax and violations, for the high possibility of tax evasion and violation in 9-13% per year. The effect of having a lot of taxation issues and understanding how to impose its tax can directly or indirectly teach people to comprehend what kind of issue taxes itself and how to count the amount of taxation to their income. (27)

The rules for firms are very similar. Also of particular importance is the tax treatment of employment and self-employment income. From 2005, the law provides that income from employment is assumed to be derived unless otherwise demonstrated, and income from self-employment is also assumed to be derived. However, with retrospective legislation effective from the commencement of the tax year 2005/06, self-employed income will be assessed on a presumptive basis.

There is no definition of income provided in the tax law, but it is generally understood as a flow of money to an individual or a household and profits as a flow of money to a firm that is susceptible to tax. Therefore, the determining factor for taxing income or profits is "source". If the source is within Egypt, the income is said to be derived, and if the source is outside Egypt, the income is said to be remitted. Generally, the country adopts the remittance basis for persons other than Egyptian nationals. (28)

1.3. Trends in tax revenues

In Egypt's case, the decline in trade taxes has not been fully compensated for by the increase in domestic taxes. The tax system as a whole is still quite regressive. This progression towards a more efficient and equitable system came to a halt in the early 1990s due to fiscal and structural adjustment programs. Program loans from the International Monetary Fund and World Bank were aimed at improving the fiscal and current account balance with a focus on lowering inflation and liberalizing trade. This resulted in a decrease in tax revenues' percentage of GDP in years 1991-1995.

Figure 1 plots total tax revenues, domestic tax revenues, and trade taxes as a percentage of GDP for the period 1974-2000. Total tax revenues have been on the rise throughout the period, starting at around 10% of GDP rising to 20% by the year 2000. (29)

This change was made in an effort to increase economic growth in Egypt. As stated by Governor Lytton of the IMF at the time of the devaluation, Egypt is on the right track to securing a medium-term agreement with low inflation and substantial economic growth. This agreement was set to secure a loan of 75 cents per SDR from the IMF, equivalent to around E£3.7 billion. IMF involvement with Egypt and future loans would be heavily influenced by the economic changes resulting from the devaluation of the exchange rate. An IMF executive board member was quoted saying any successor program should aim at entrenching the gains and advance the authorities' efforts to boost economic growth and sustain a reduction in poverty. (30)

This event has major implications for future economic policy and economic growth in trying to secure a loan from what is essentially a restructuring program for the Egyptian economy with the future loan being considered a continuation from the last loan program just before this agreement. The IMF executive board member also expressed that they would stand by Egypt in support of its economic reform program and continue to assist its aim of securing high and sustainable economic growth and improve the standard of living for the Egyptian people. A strategy to increase economic growth and improve the standard of living for the people would ideally be funded by multilateral agencies such as the IMF who provide loans with the intention of restructuring and developing the economy. With future loan programs and a strategy to increase economic growth in mind, we would expect to see corrective effects from the devaluation of the exchange on the economic policy of Egypt during the loan programs and the efforts to improve economic growth and the living standards of the people. (31)

Import taxes are imposed on goods coming into the country from abroad. These taxes are imposed in terms of a percentage of the value of the goods, and are paid to the port authority in foreign exchange, regardless of the currency involved in terms of the transaction between the importer and the foreign exporter. When the importer in Egypt purchases foreign exchange to pay for the cost of imported goods, the imported component of the money supply rises. (32)

In order to buy foreign exchange, the importer demands foreign currency which is supplied by selling his pounds. This increase in the demand for foreign exchange causes an appreciation in the foreign exchange rate. Now in Egypt it is a well-known fact that an increase in the exchange rate will cause a fall in the demand for both exports and imports. However, it is important to distinguish between the long run and short run elasticities of demand for exports and imports. Studies have shown that short run demand elasticities for exports and imports are relatively low, and long run studies have shown that the dynamic shifts in import-export quantities resulting from the changes in the exchange rate have been very slow. (33)

At first sight, one may think that an appreciated exchange rate is bad for export industries and good for import competing industries, and a depreciated exchange rate would be bad for import competing industries and good for export industries. However, under the conditions of low own price elasticities for both imports and exports (which the Egyptian economy is very close to), the above statement is not necessarily true. If we assume that import taxes are aimed at protecting import competing industries. Then when import taxes are imposed and there is an appreciation of the foreign exchange rate, the increased demand for forex will cause the appreciation of the foreign exchange rate and reduced revenue from tariffs. Next, it is necessary to look at the nature of tax incidence of import tariffs. (34)

If an imported good is inelastically demanded, then the burden of the tax will fall on the consumer of that good, given that there are no good substitutes for it produced domestically. The consumer will have to pay a higher price for the imported good and tax revenue will be relatively low. Although most imported goods have close substitutes with domestic production, and the tax incidence will cause a reduction in the quantity of imports of that good and relative rise in price. This is caused by the relatively low own exchange elasticity for imports and the principle that a tariff will always increase the price of the good and a fall in the change quantity of that good demanded.

DISCUSSION & CONCLUSIONS

The study establishes a connection between the Floating Egyptian Pound and Tax Revenues in Egypt, drawing on data spanning a specific period.

the relation between the Floating Egyptian Pound and Tax Revenues in Egypt is significant in the short run, Exchange Rate Volatility Fluctuations in the Floating Egyptian Pound can directly impact the value of imports and exports, affecting the tax revenues generated from international trade in the short term.

Inflation Effects Changes in the value of the Egyptian Pound may lead to fluctuations in domestic prices, influencing consumer spending and subsequently impacting tax revenues collected from consumption taxes in the short term.

Foreign Direct Investment (FDI) The exchange rate regime can influence FDI inflows, which may have immediate effects on economic activity and corporate tax revenues.

Government Policy Response Short-term adjustments in tax policies or fiscal measures in response to exchange rate fluctuations can directly affect tax revenues during the same period.

Market Sentiment and Investor Confidence Perception of the stability of the Egyptian Pound in the short term can affect investor confidence and capital flows, influencing tax revenues derived from investment-related activities.

Recommendations:

1. Increasing Foreign Direct Investment (FDI) is significant. The exchange rate regime can influence FDI inflows, which may have immediate effects on economic activity and corporate tax revenues.
2. Reducing and controlling inflation rates receive significant attention due to their adverse effects on both economic growth and government tax revenues.
3. Reducing and controlling fluctuations in Exchange Rate Volatility in the Floating Egyptian Pound can directly influence the value of imports and exports, thereby affecting the tax revenues generated from international trade in the short term.
4. Working on implementing digital transformation in tax administration to utilize it in developing and enhancing tax collection.

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