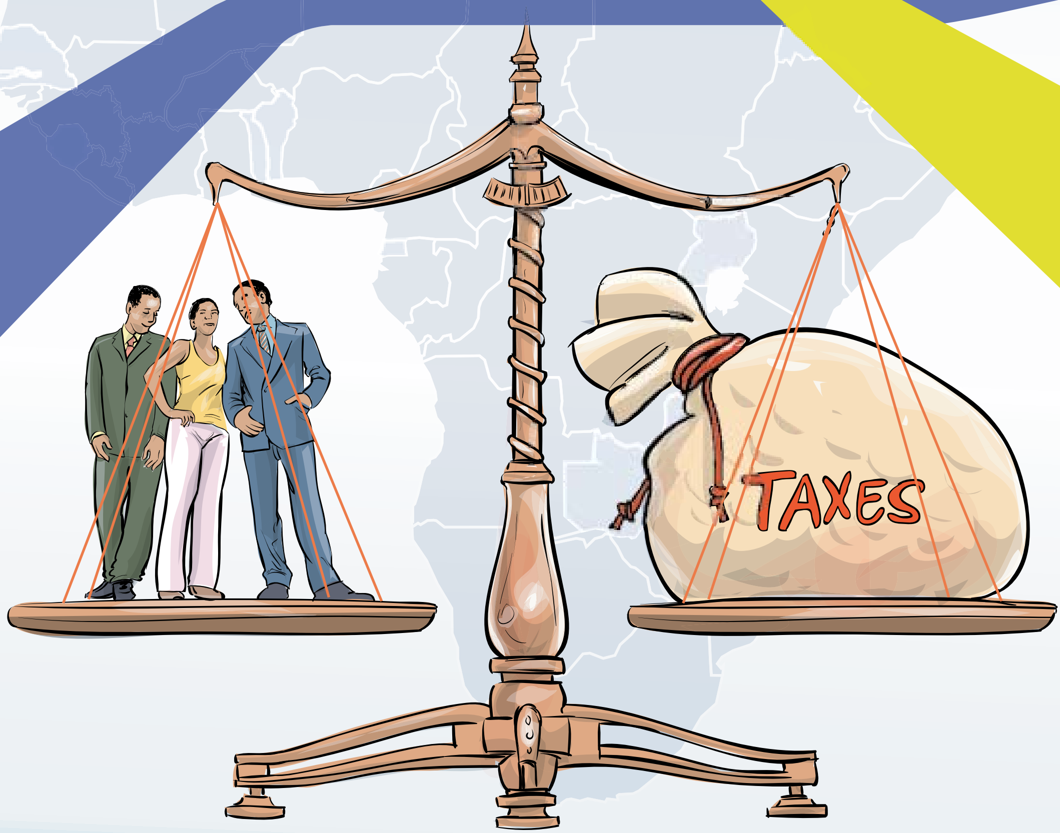
ADDRESSING INEQUALITY IN AFRICA THROUGH TAXATION



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The core content of this booklet was based on research by Bernadette Wanjala.
The following people contributed in reviewing this document: Thembinkosi Dlamini, Matti Kohonen, Vitus Azeem.
The final content was edited by Conor Joyce.

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Contact Information

For any query on the document, please contact Sandra Kidwingira on the following address: infoafrica@taxjustice.net

The Tax Justice Network - Africa
Tigoni Rd. off Argwings Kodhek Rd. opp. Yaya Centre
P.O. Box 25112-00100, Nairobi, Kenya
Tel: +254 20 2473373
Mobile: +254 728 279 368
Website: www.taxjusice4africa.net

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Illustration: Joe Barasa

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Executive Summary

Taxation is the main source of finance for most governments. Besides being used to raise revenue to fund government operations, taxation is used to assist in the redistribution of wealth or income and to regulate economic activities. The distribution of the tax burden has major implications for levels of equality and inequality. An equitable tax system implies that everyone pays according to his or her own ability. A more equitable tax system is one which ensures that individuals with higher incomes bear a greater tax burden compared to individuals on lower incomes. For instance, a tax system is equitable if persons or businesses in similar circumstances have similar tax burdens ('Horizontal Equity') and also if people with a greater ability to pay taxes pay more as compared to poor people ('Vertical Equity'). In addition, taxes are progressive if the tax burden is borne disproportionately by the wealthier segments of the society, while taxes are regressive if poorer segments of the society bear a greater burden.

The distribution of the burden of a tax determines how a tax can be used to achieve income redistribution. Income redistribution can be achieved by the provision of cash transfers to low-income individuals through social welfare programs, by the use of an income tax threshold to exempt certain low-income individuals from the income tax net and by the use of provisions (such as tax deductibility of individual pension schemes, of life-insurance premium payments, of mortgage interest costs and education fees) that seek to reduce the tax burden of low- and middle-income individuals. Income and wealth taxes on individuals are the primary instruments for achieving income redistribution, although this also requires a progressive tax system that is effective. However, the taxation of capital gains, rental income and other income from properties poses great challenges in attempts to achieve equitable tax systems. Taxation of the informal sector also remains a big challenge, especially in cases where the informal sector is large, as it undermines the use of the tax system to achieve income redistribution. Tax avoidance and tax evasion are also major challenges which limit revenue mobilization.

A progressive tax system supports development in several ways. Progressive taxation may result in higher revenues, less financial and economic volatility, and faster economic growth. Increased revenues tend to imply increased access to public services, and more revenue allocation towards poverty reduction efforts. More progressive taxation can also translate into the generation of more stable, long-term financial resources and a greater ability of policymakers to engage in countercyclical fiscal policies. It can also indirectly affect economic growth by reducing income inequality and also improve the way in which an economy automatically stabilizes itself using the country's fiscal system. Given the importance of progressive tax systems in achieving social justice and supporting development, efforts should be made to ensure that tax systems are progressive.

1 Introduction

Equity is most commonly defined as 'the quality of being fair and impartial', and an equitable society is one that is based on equity and social justice. An equitable society needs an equitable tax system, i.e. a tax system in which everyone is treated fairly and equally. It is a tax system in which everyone must pay his or her fair share, taking into account his or her ability to pay. So far, so clear but what is tax? Surely everyone knows what tax is, so there is perhaps no need to define it. But does everyone know what it is? What is tax?

Rather than try to define a word or a term, it is often better to give its use and to try to identify what the reality or institution, to which the word or term refers, is for. (A definition is provided in the glossary at the back of the booklet.) A government needs revenue to run the operations of the economy, especially to fund public expenditure. One of the key sources of revenue for governments is taxation. Tax systems tend to have three main objectives. These are

(i) to raise revenue to fund government operations;
(ii) to assist in the redistribution of wealth and income and
(iii) to regulate economic activities.

Of these (ii) to assist in the redistribution of wealth and income, has most to do directly with tax equity, for one of the goals of this redistribution is to create a fair or fairer society. The use of tax provisions to regulate economic activities is an important part of a state's management of a market economy. Taxes can serve as incentives or disincentives for particular types of economic activity. Various instruments – such as the ability to write investment expenditure off against tax – are adjusted depending on the economic situation of the country. Tax incentives such as subsidies, exemptions, rebates and tax holidays affect the level of competitiveness of businesses. Using the tax system to regulate and adjust economic activity provides a government with a crucial mechanism – a set of levers – with which to actively manage a country's economy, and to fine-tune its management on an on-going basis.

In addition to the three main objectives listed above, taxation is also commonly used to encourage valued activities like savings and investment as well as to discourage activities that are harmful such as smoking or are considered harmful such as gambling and drinking. A further goal of taxation is the strengthening

"Have you seen the new tax return forms? It's been simplified... No need to procrastinate and submit them late... "

and protection of channels of political representation. Country comparison research has shown that, at all levels of national income, the higher the share of tax revenue is in government expenditure – the more governments rely on tax revenues – the stronger are channels of political representation in that country1. The strongest relationship exists where citizens contribute most to state revenue through the taxation of personal income and through corporate profits. The extent to which the objectives of taxation are met differs widely, of course, across countries. National levels of taxation also lead to tax competition between countries, as those with lower levels of taxation are more likely to attract foreign investment than countries with higher taxes.

The distribution of the tax burden – how much it weighs on the different socio-economic and demographic groups in a society – and the effect of taxes on inequality are at the centre of the debate on public finance. A better understanding of the distribution of the tax burden is important in the formulation and assessment of tax systems. However, information on taxation and on its impact on inequality is lacking or inadequate in most African countries. Discussion and debate on taxation matters have usually been left just to policymakers. There is a need for the citizens to play a more active role in ensuring that tax systems are progressive and equitable. This booklet aims to provide an understanding of the issue of equitable taxation and its relevance in aiding economic development.

2 The Structure of Tax Systems

Before proceeding to the issue of tax equity, it is worth setting out some further basic distinctions in the tax area, as these will help when it comes to discussing tax equity in more detail.

Tax systems usually incorporate into two main types of tax: direct taxes and indirect taxes.

- Direct taxes are those paid directly paid by taxpayers, that is, by individuals or companies. Direct taxes are mainly taxes on personal income or corporate profit. Other types of direct tax include capital gains tax and land value tax.
- Indirect taxes are those collected by an intermediary, where the final tax burden is borne by a different person, such as the consumer. Indirect taxes are mainly consumption taxes. The tax is effectively passed on by the intermediary to the consumer through an increase in prices. Indirect taxes include Value Added Tax (VAT), excise tax, customs and stamp duties.

In addition to tax revenue, there are various sources of non-tax revenue that have been applied in many African countries, most notably resource rents. Where an economy's revenue is dominated by resource rents, the entire tax system will be distorted because two of the key objectives of a tax system – namely (i) to assist in the redistribution of wealth and income and (ii) to regulate economic activities – either cannot be achieved or can only be achieved to a minimal degree. Such a simple tax system will not have enough definition or structure to deliver on these goals.

The structure of a developed tax system implies that taxpayers do not pay only one particular type of tax but pay several, either directly (like income taxes) or indirectly (like taxes on consumption such as VAT and excise). This does not necessarily amount to double taxation. The use of multiple instruments for taxation has both advantages and disadvantages. On the positive side, diversifying the tax system can provide insulation against economic shocks which might impact more strongly of there is only one particular tax in place. If tax revenue from one type of tax falls, then the revenue loss can be compensated for through another type of tax. For example, most African countries have experienced lower revenues from trade taxes as a result of regional integration, and this has necessitated a shift to domestic taxes such as excise or VAT to mitigate against the revenue

*"What do you mean you feel like your life has no meaning?
You do pay taxes, don't you?*

loss. A second advantage of multiple tax types is that it allows lower rates of tax across the various types of tax, thereby reducing what is known as the 'excess tax burden' or 'distortionary effect' of a tax. This is the economic loss that a society suffers as the result of a tax, over and above the revenue it collects. Distortions occur mainly because people or firms change their behaviour in order to reduce the amount of tax that they must pay. The distortionary effect of a tax – the excess tax burden – increases with the tax rate since the higher the tax rate, the more likely the taxpayer is to change her or his behaviour in order to reduce the tax burden. A third advantage of diversifying the types of tax is political: it creates engagement with a broader range of interest groups and socio-economic categories. Also, multiple tax bases tend to reduce evasion or avoidance because taxpayers are unlikely to be able to avoid all taxes.

Among the disadvantages of using multiple taxes is that it makes the system more complex, and therefore increases administrative costs. Also, diversification will not necessarily reduce distortions if several taxes apply to one good or service, for example to a commodity that may attract both excise tax and VAT. In certain situations, the total distortionary effect – the excess tax burden – will be increased by multiple taxes. It is also not easy to determine the distribution of the tax burden on individuals and socio-economic groups when a number of instruments are applied and also when numerous tax exemptions are operative in the tax system. Overall, however, it can be claimed that there are more disadvantages than advantages to using multiple taxes.

3 Principles of Taxation

Tax equity is but one of a number of general principles that guide tax policy. It is worth briefly introducing the other principles here. Besides tax equity, the most common are the principles of

(i) neutrality
(ii) simplicity
(iii) adequacy and
(iv) exportability

(i) Neutrality means that imposing a tax does not affect individuals' or companies' economic decisions.
(ii) Simplicity ensures that the tax collection and assessment system do not impose costs greater than the revenue raised. Having too many types of tax exemptions not only makes the tax system more complex but also increases collection and administration costs, and can do this to a point where the level of tax revenue that is collected is – net of costs – lowered.
(iii) An **adequate tax system** raises enough money to pay for public services. One key factor that contributes to the generation of adequate revenue is the notion of predictability: tax revenues need to be predictable.
(iv) Exportability refers to the extent to which taxes are paid for by non-residents, for example, an export tax. Taxes that are exportable generate revenues from non-residents (individuals or businesses) who enjoy public services provided by state and local taxes. One tax that falls into this category is sales taxes paid by tourists, and also other supplemental taxes on hotel rooms and rental cars.

Tax equity can be thought of as the fifth principle of taxation.

3.1 Horizontal and Vertical Equity

There are two measures of tax equity: horizontal and vertical. A system is horizontally equitable if persons or businesses in similar circumstances – in terms of material well-being – have similar tax burdens. Taxes that affect one group (such as wage-earners) more harshly than another (such as investors) are not equitable. Income tax is an example of this disparity.

Consider three illustrations of horizontal inequity, all examples of national tax-break systems, where some companies receive special tax treatments (such as an Export Processing Zone (EPZ for short) or Special Economic Zone treatment) while other companies pay the normal level of taxes.

1. Tax benefits for EPZs in Kenya include:
   - a ten-year corporate income tax holiday and a 25 percent tax rate for a further 10 years thereafter (except for EPZ commercial enterprises – those dealing in commercial activities (breaking bulk, repackaging, re-labelling and trading);
   - a ten-year withholding tax holiday on dividends and other remittances to non-resident parties (except for EPZ commercial licence enterprises);
   - perpetual exemption from VAT and customs import duties on inputs – raw materials, machinery, office equipment, certain petroleum fuel for boilers and generators, building materials and other supplies; VAT exemption also applies to local purchases of goods and services supplied by companies in the Kenyan domestic market;
   - perpetual exemption from payment of stamp duty on legal instruments;
   - a 100 percent tax deduction on new investment in EPZ buildings and machinery that can be written off over 20 years.

In Cameroon, tax concessions available in the free zone regime for enterprises producing exclusively for export include:
   - a ten-year tax holiday on all taxes;
   - a flat tax of 15 percent on corporate profits beginning in the eleventh year, and continued exoneration on all other taxes in perpetuity;
   - a right to carry profit or loss over from one year to another.

In Nigeria, tax incentives for EPZs include:
   - a complete tax holiday from all Federal, State and Local Government taxes, rates, customs duties and levies;
   - the duty-free, tax-free import of raw materials and components for goods destined for re-export.
   - the duty-free introduction of capital goods, consumer goods, machinery, equipment, and furniture.

Vertical equity refers to the idea that people with a greater ability to pay taxes should pay more, that is, that individuals earning higher incomes, or wealthier individuals, should pay higher levels of tax compared to poorer people. Vertical equity also implies a sliding scale i.e. that the more people earn or the wealthier they are, the more tax they should pay, which implies in its turn that the poorer individuals are, the less they should pay in tax.

The classic example of a progressive tax is personal income tax. Consider the South African income tax system with the income tax rates for 1st April 2009 to 31st March 2010 as shown below. Suppose that there are three individuals, with A earning R 130,000, B earning R 260,000 and C earning R 600,000.

The South African Income Tax Structure (1st April 2009 to 31st March 2010) is as follows:

Taxable income (Rand)	Rates of tax
0 – 132 000	18% of each Rand
132 001 –210 000	R23 760 +25% of the amount above R132000
210 001 –290 000	R43 260 +30% of the amount above R210 000
290 001 –410 000	R67 260 +35% of the amount above R290 000
410 001 –525 000	R109 260 +38% of the amount above R410000
525 001 and above	R152 960 +40% of the amount above R525 000

Using the tax rates shown above, individual A will pay R 23,400 in taxes (about 18 percent of his or her total income), individual B will pay R 55,760 in taxes (about 21 percent of total income) and individual C will pay R 182,960 (about 31 percent of total income). Thus this income tax system can be said to be progressive given that the tax burden increases with income, that is, the more income one earns, the more the tax is payable.

Consider the Ghanaian income tax system and three individuals, with A earning GHS (Ghanaian Cedi) 1,000, B earning GHS 5,000 and C earning GHS 10,000.

The Ghanaian income tax structure for 2009 is as follows:

Taxable income (GHS)	Tax rate
First 240	Free
Next 240	5%
Next 1,200	10%
Next 7,920	17.5%
Exceeding 9,600	25%

Using the tax rates shown above, individual A will pay GHS 64 in taxes (about 6 percent of his or her total income), individual B will pay GHS 713 in taxes (about 14 percent of total income) and individual C will pay GHS 1,618 (about 17 percent of total income). So this income tax system is also progressive.

3.2 Progressive and regressive taxation

Progressive and regressive taxation are the most important concepts in the area of vertical equity. A progressive tax is a tax that has vertical equity built into it. A tax rate is progressive that rises in proportion to an individual's ability to pay i.e. in proportion to his or her income or wealth. Higher tax rates are imposed on higher taxable amounts, so that the tax burden is borne disproportionately by the wealthier segments of the society. A progressive tax rate is graduated, with the rate increasing the higher an individual's income or wealth. Although theoretically applicable to any kind of tax, the term 'progressive taxation' is most frequently applied to income tax, given the difficulty of applying progressive rates to, for example, a VAT or excise levy.

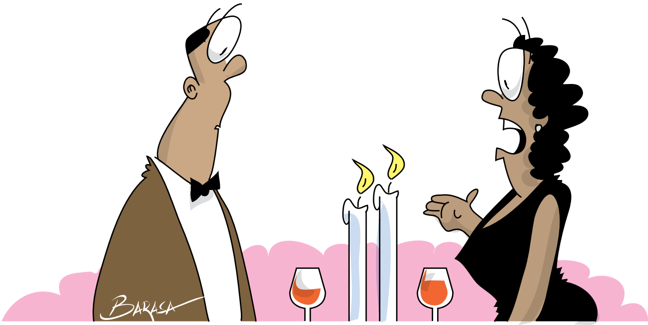
There are various arguments for and against progressive tax systems. Some of the main arguments in their favour are:

(i) progressivity is a tool to redistribute income;
(ii) the wealthy benefit more from government activities and should for this reason pay more to support them (This is known as the 'benefit theory');
(iii) the marginal utility of money is a diminishing one, that is to say, wealthier people derive less satisfaction from each additional dollar of income and hence are in a position to be more ready to part with it.

Arguments against progressivity include:

(i) it is the individual's right to retain the fruits of his or her labours, so taxing him or her more for having reaped higher fruits is unfair;
(ii) there are negative effects of progressive rates on incentives, that is, individuals can choose to earn less or choose to declare less income to avoid paying higher taxes, through tax avoidance or tax evasion.

A regressive tax is one that requires lower-income individuals to pay a greater percentage of their income towards that tax than higher-income individuals. The classic regressive tax is a sales or Value Added Tax (VAT). VAT is ultimately a tax on goods and services and thus is a tax on consumption. Conventional economic wisdom holds that consumption taxes are passed on to the consumer. Since poorer people spend a greater percentage of their annual income on consumption, they thus pay a greater percentage of their income in VAT. So VAT is a regressive tax.



"Stop worrying so much about our wayward teenage children... When they grow up and start paying taxes, they will learn what it is to be responsible..."

The regressivity of VAT is the reason why some governments zero-rate basic commodities as a means of making the system more pro-poor. Studies have confirmed that VAT regressivity can be partially removed by exempting or zero-rating basic commodities. A recent study revealed that, out of 105 countries with VAT by the year 2003, about 50 developing countries exempted foodstuffs from the tax, while 26 (mainly industrialized economies) applied reduced rates2. In SADC (Southern and Developing) countries, the following categories of goods and services were among those exempt in a bid to improve the distributional impact of VAT: basic foodstuffs, water, medicines, pharmaceutical products, newspapers, books, agricultural inputs (seeds, fertilizer, animal feeds), public passenger transport and handicraft products.

Countries that maintain progressive tax systems tend to take a number of measures to remove or dilute the regressivity of VAT. For example, its implementation is often accompanied by other progressive provisions besides the exclusion of basic consumption items, such as the taxation of luxury items at a higher charge. The progresssivity or regressivity of customs duties depends on what kinds of goods are imported i.e. to what extent they are basic commodities or luxuries. There is a need for regular study of the efficiency of applying different tax rates (often called 'tax expenditure', which is the cost of exemptions). This type of analysis is largely lacking in most African countries, except for Morocco.

Most African countries impose a progressive system of income taxes. In addition, they levy VAT (Value Added Tax) which is mostly regarded as regressive. However, to reduce the regressivity of the VAT, most African countries have exempted and zero-rated basic commodities that are mainly consumed by the poor.

4 The Tax Burden and the Use of Taxation as a Redistributive Tool

To create a fairer, more equitable, tax system, taxation is used as a redistributive tool. But to be so used, there must ways to determine to what degree individuals and companies, within a country's tax net, are actually bearing the weight imposed by the tax regime. This is where the concept of the tax burden comes in.

4.1 The Tax Burden

The tax burden refers to the amount of tax borne by an individual or company; this may not be the same as the tax actually paid because of the possibility of passing a tax on. This distinction helps explain why there are two fundamental concerns in public finance: who has the legal liability of a tax – who has the 'statutory burden' – and who actually bears the ultimate burden of the tax – who has the tax burden i.e. bears the economic incidence of the tax.

At the level of the individual, the determination of who pays a tax is not straightforward. It requires empirical analysis, which is lacking in most African countries. However, using a mixture of theory and practice (as applied in formulating policies), various assumptions can be made with regard to the incidence of taxes.

• Personal income tax can be assumed to be wholly borne by its payers with the result that a progressive income tax system will yield a progressive tax burden.
• There is no agreement about how much corporate tax is passed on. It is sometimes assumed that it is not passed on, which would imply that shareholders pay the tax in full. But it is also often assumed that corporate tax is passed on where the existing market structure allows this, so that the burden is shifted to consumers in the form of higher consumer prices.
• Consumption taxes (VAT, sales tax, excise and trade taxes) are assumed to be borne by the final consumer.
• The incidence of property taxes, i.e. where the tax burden falls, is also controversial. It can be fully borne by capital owners or shifted to tenants, fully or in part.

The term 'tax burden' is also used at the national level where it means something different. There it is a measure of the proportion of taxes in a country's Gross Domestic Product (GDP). The higher the proportion of tax revenue in GDP, the higher is the burden on the citizens of the country. Countries in Africa with the highest tax burden in 2009/10 (need to be more precise about what 2009/2010 means here; perhaps complicated by the fact that countries have different tax year ends) include Seychelles (with 28.1 percent of GDP), Botswana (25.4 percent), Namibia (28.1 percent), South Africa (25.7 percent), Cape Verde (22.6 percent), Morocco (25.5 percent), and Tunisia 22.5 percent. Countries with the lowest tax burdens include Libya (with 2.7 percent of GDP), Angola (5.7 percent), Nigeria (6.1 percent), Algeria (7.7 percent) and Central African Republic (7.7 percent). Note that all these figures exclude oil, mineral and non-tax revenues so they are not strictly comparable. A common characteristic of the countries with the lowest tax to GDP ratios is that they have mineral resources, which are a source of revenue that is used to supplement tax revenue.

4.2 Taxation as a Redistributive Tool

A government can use the distribution of the tax burden to achieve its redistribution objectives. The tax burden can be shifted between agents by using a progressive tax system – coupled with tax exemptions – and also by altering economic behaviour through changes in prices. The extent to which this causes a shift depends on how the demand and supply of goods and services changes as a result of changes in prices and income, and also depends on the level of substitution between labour and capital. Taxpayers who cannot substitute the good that is being taxed with another good are more likely to bear a greater tax burden as compared with those taxpayers who have the ability to change their consumption patterns.

The distribution of the burden of a tax determines how a tax instrument can be used in achieving income redistribution. A more equitable tax system is one that ensures that individuals with higher incomes bear a greater tax burden as compared to individuals with lower incomes. Therefore, an equitable distribution of income is associated with a tax system that has tax rates that increase with income (i.e. persons with higher incomes should fall in higher income tax brackets).

Tax instruments vary greatly in their ability to redistribute wealth or income, both in theory and in reality. Individual income tax and wealth taxes are the primary instruments for achieving income redistribution. However, achieving a redistributive policy via the income tax system can only be achieved if the progressive tax system is effective. Progressivity is most commonly achieved by having progressively higher marginal tax rates. An analysis of income tax reforms over time in most African countries has revealed that, although though the number of income tax brackets has been considerably by widening most brackets, progressivity has been maintained by increasing the income tax threshold level and also by increasing levels of personal tax relief.

One of the major challenges for, and most glaring weaknesses, of most African tax systems is their failure to tax capital gains. This failure, common across most of Sub-Saharan Africa, represents a major revenue loss, and erodes the redistributive capacity of the tax system. Higher marginal taxes on rental properties are claimed to be pro-poor and to promote equity, on the grounds that landlords and property owners are typically rich and thus should be taxed more.

In Ghana, net capital gains on the sale of properties are, as of 2010, taxed at 5 percent. But original acquisition costs, improvement costs, and legal fees and other expenses necessarily incurred in the process of selling the property, are deductible. Net gains not exceeding GHS50 are exempt. Gains are also exempt if the entire amount is reinvested in another property within a year, or if the transfer of ownership is to the taxpayer's spouse, child, parent, brother, sister, aunt, uncle, nephew or niece. In Botswana, capital gains from the disposal of immovable property are taxed at progressive rates, varying from 5 to 25 percent, but the first BWP (Botswana Pula) 15,000 (approx. US$ 2,108) is not taxable.

The taxation of rental income

Rental income obviously forms a significant proportion of the income earned by property owners. In Kenya, rental income is taxed at 30 percent (the same as corporate profit), and this is considered equitable, but only if the cost is not shifted to tenants through increased rent. In Ghana, rental income is subject to a final withholding tax of 15 percent which is levied on the gross income. In Botswana, rental income is taxed at progressive rates, ranging from 5 to 25 percent.

Property tax

Most African countries do not levy property taxes even though they can play a significant role in aiding wealth redistribution. In Kenya, property taxes are levied by the local government (not central government), with a rate of about 1 percent of the value of the property. Land rates are also applicable, but vary with location. The way in which these variations are designed can bring about horizontal inequity. The fact that the rates are varied at the discretion of the administration can be an avenue for corruption and mismanagement. In Ghana, property tax is also levied annually by local authorities on the estimated value of the property, depending on the classification of the area where it is located, with the rates range from 0.5 to 3 percent.

Overall, the taxation of wealth and of property income remains a challenge. Even in countries where taxes are levied on property and rental income, the revenue is minimal, which implies that the potential tax take from of wealth and property is not being well captured. Lower tax compliance could be a result of the rich being able to place their wealth in tax havens, where they either do not pay taxes or pay them at a lower rate. The taxation of property and wealth requires identification of the relevant tax base, for example, in the case of property, it requires reliable records of land ownership, to ensure that all property assets are brought into the tax net. An example of an attempt to tax wealth is the recently introduced Kenyan requirement whereby tenants are required to provide details of their landlords when filling in their tax returns, so providing information on ownership of properties. If captured, the taxation of wealth and of property income are one of the main ways through which income redistribution could be achieved.

5 Taxation and Inequality

A tax reduces inequality if it lightens the tax burden on the poor and ensures a greater burden on the better off. For instance, VAT can be used to reduce inequality by exempting from the tax basic commodities and necessities such as foodstuffs which are mainly consumed by the poor and by taxing luxury items more, which are mainly consumed by the rich. Similarly, a progressive income tax can aid in reducing inequality by taxing individuals with higher levels of income more than those with lower levels of income.

Inequality and progressivity are related but quite distinct concepts. Inequality is defined by welfare economists over the entire income distribution, while progressivity focuses on relative average tax rates faced by various income categories. Looking at international experience, there are three major ways through which the redistribution goal can be achieved via the tax system.

(i) The tax system can be used as part of a social welfare program to provide cash transfers to low-income individuals. A good example is the basic income grant in Namibia, which was found to significantly reduce poverty and unemployment, and improve health, nutrition and education outcomes. It was estimated that the number of severely poor households reduced from 86 percent to 68 percent and food poverty from 76 percent to 37 percent in the region where it was implemented in 2008.
(ii) A high income tax threshold can be used to exempt low-income individuals from the income tax net.
(iii) Provisions can be adopted that seek to reduce the tax burden of low- and middle-income individuals; such provisions include tax deductibility of individual pension schemes, of life-insurance premium payments, of mortgage interest costs and education policies. The most commonly applied tool in most African countries is the second option whereby high income tax thresholds are applied to exempt low-income earners. This has been applied in addition to a progressive income tax system, which has meant that individuals with lower income levels bear lower levels of tax burden.

The question, however, remains open as to what extent progressive income tax systems have helped to reduce inequality. Research has shown that income taxes have not played a major role in reducing inequality in developing countries1. In these countries, the effects of progressive income taxation have generally been smaller than the distributional impacts of consumption taxes such as VAT and excise taxes. This is because the poor are effectively outside the tax net because of higher levels of tax relief and higher tax thresholds, and this undermines the effectiveness of using income tax as a redistribution tool. Relying on a progressive income tax to accomplish a desired redistribution in developing countries may often amount to little more than 'digging deeply with a sieve'.[2] Therefore, expenditure can be a more effective redistributive tool than income taxation, which is why the option of using social welfare programmes in addition to a redistributive tax policy is important.

5.1 Taxation of the informal sector and its implications for inequality and equitable taxation

A country's taxation of its informal sector has considerable implications for inequality and for the fairness of its tax system. There are various definitions of the informal sector. A commonly used one is "all currently unregistered economic activities that contribute to the officially calculated (or observed) Gross National Product".[3] The informal sector includes those economic activities and the income derived from them that circumvent government regulation, taxation or observation. It thus includes unreported income from the production of legal goods and services, either from monetary or barter transactions, and so the sector includes all economic activities that would generally be taxable were they reported to the tax authorities.

One of the greatest challenges to tax administrations around the world has been, and remains, the difficulty of bringing the informal sector into the tax system. It is difficult to estimate the precise size of this sector owing to the fact that it is, by definition, hidden from official scrutiny. However, several researchers have made attempts to estimate the size of the informal sector, and it has been found in Africa to be typically quite large. A survey of its size in several African countries revealed that on average, the size of the informal sector in Africa was estimated to be, for the tax year 1999/2000, 41 percent of "official" GDP.[4] Zimbabwe, Tanzania and Nigeria were estimated to have the largest shadow economies, with 59.4 percent, 58.3 percent and 57.9 percent respectively. In the middle were Mozambique, The Ivory Coast and Madagascar with 40.3 percent, 39.9 percent and 39.6 percent respectively. The countries with the lowest proportions in the informal sector were Botswana with 33.4 percent, Cameroon with 32.8 percent and South Africa with 28 percent; these figures can be attributed to the large extractive sectors –that are easier to tax – in Botswana, Cameroon and South Africa, and can also be in part attributed in the case of South Africa to the widening of its tax net in line with its status as a middle-income country.

The implications of the informal sector for tax policy and the distribution of the tax burden are numerous. If the informal sector is large, this means that only a small proportion of the population operating in the formal sector bears the tax burden. This has implications on the extent to which tax policy can be used to achieve redistribution and consequently reduce inequality. In most cases, such economies largely rely on direct income taxes, which puts a heavy burden on those whose income falls within the tax system. Furthermore, the proportion of wage income within the tax system is lower given the fact that in most African countries, formal employment does not grow as fast as employment in the informal sector, leading to an invisibility of growth referred to as 'the missing middle'. For these reasons, increasing the role of consumption taxes is often used to compensate for the downward pressure on tax revenues; relying more on revenues from consumption taxes can also reduce the budgetary pressure on enterprises moving into, or partly into, the formal sector, by reducing the state's need to increase corporate tax rates.

To some extent, VAT functions in many African countries as what is called a 'presumptive tax'. This refers to any rough and ready but effective way of raising revenue whenever a government lacks the capacity to raise sufficient income tax, which happens especially where agriculture is a very large sector and where the informal economy is also large. The way VAT works 'presumptively' is as follows: because VAT credits are available only to registered firms, a system of VAT credits means that those operating in the shadow sector are taxed when they purchase formal-sector commodities, as they almost always need to a considerable for both business and consumption purposes. The net benefit of being informal will therefore be the net tax, this being the difference between the VAT tax and the VAT credit.

For a country to pursue a tax policy that is supportive of inequality reduction, there is a need to reduce the size of the growing informal sector, which can be done by encouraging formal registration of enterprises operating in that sector. A substantial reduction of the informal sector leads to a significant increase in tax revenues and therefore to a greater quantity and quality of public goods and services, and this is both conducive to lessening inequality and stimulates economic growth.

5.2 Tax Avoidance and Tax Evasion

Tax avoidance and tax evasion are two of the major challenges facing modern tax systems. Tax avoidance is the term given to the practice of seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud). The term is sometimes used to refer to the legitimate minimization of taxes, using methods approved by the revenue authority, such as the claiming of allowances and reliefs. It is, however, now generally agreed that this is not tax avoidance. If the law provides that no tax is due on a transaction then no tax can have been avoided by undertaking it. This practice is now generally seen as being tax compliant. So what the term tax avoidance now usually refers to is the practice of seeking to not pay tax that is in keeping with the letter of the law but is contrary to the spirit of the law. This is also called aggressive tax avoidance. Tax evasion, on the other hand, is the illegal practice of not paying taxes, by not reporting income, reporting expenses not legally allowed, or by not paying taxes owed.

Tax avoidance and tax evasion are widely believed to be important factors limiting revenue mobilization. Tax revenue losses due to tax avoidance and tax evasion in developing countries can be sub-divided into two components: domestic and international. The domestic component is mainly due to tax avoidance and evasion by the informal sector. It has been estimated that developing countries lose

Why does the US tax system work more effectively than those of most African countries? The American federal income tax system applies marginal tax rates that increase with income, and is considered quite progressive. There are several characteristics that enable the country to pursue a progressive federal income tax system. As in other advanced economies, the relatively large administrative resources at the disposal of the U.S. government, and the large size and power of the country generally, put it in a relatively strong position to enforce its will on progressivity and other tax-related matters, so that tax policy is thought of as a series of autonomous choices rather than decisions forced upon citizens by outside actors, as is the case for most African countries. In addition, the tax legislative process in the U.S. is further characterized by a division of power and influence between a large number of congressional and other actors (including civil society and other interest groups), and between state and federal governments. In a large and developed economy such as the U.S., thinking about equity and fairness is informed by measurable economic data, typically, by what percentage of tax is paid by each "quintile" of the population, and a clear distinction operates between horizontal equity and vertical equity; these are practically lacking in most African countries.

US$285 billion per year due to tax evasion in the domestic shadow economy5. The international component on the other hand includes the booking abroad of profits by companies and the holding offshore of financial assets by private individuals. Estimates of revenue losses suffered by developing countries due to corporate moving of profits between countries range between approximately US$35billion and US$160 billion per year. There is no reliable data on tax gaps for most African countries, mainly because of the lack of relevant data required for such analysis.

Tax capacity – the revenue potential – remains low in many African countries, even though very few in-depth studies have been carried out to assess the level of revenue capacity. A 2004 study of Kenya sought to assess this level on a tax by tax basis6. With the 'tax effort' defined as the proportion of tax revenue that is collected compared to the actual revenue potential, the analysis revealed that the tax effort for personal income tax was about 70 percent in the year starting 1st July 2001 to 30th June 2002, implying a 30 percent tax compliance gap. The tax effort for corporate tax was only 35 percent for the same year, while the VAT effort was 56 percent. Import duties had a tax effort of 49 percent, which was mainly due to the numerous exemptions being applied to import taxation. The excise tax effort for beer and cigarettes was 85.2 percent and 52 percent respectively. These tax compliance gaps could mainly be attributed to a combination of tax avoidance and tax evasion.

Treating different types of income taxes differently can lead to tax avoidance or evasion, as a taxpayer can be tempted to declare income in the category that attracts the lowest tax rate, where this is sometimes against the spirit of the law or is actual mis-reporting. Where the personal income tax rate is higher than the corporate tax rate, it is not uncommon to declare all income under the corporate category, and vice versa. This can be a case of tax evasion through under-declaration, and will most likely happen when the tax policy structure does not have a clear enough distinction between individual income and corporate profit, and also when the enforcement authority does not have the capacity to counter-check the declared sources of income and profit. This is one of the major reasons for low tax compliance in most African countries.

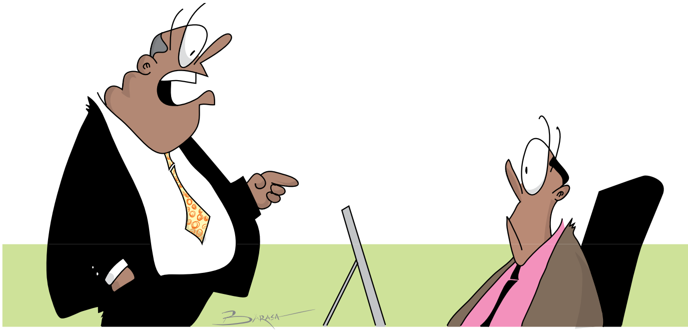
6 Where now?

This booklet has sought to provide a better understanding of taxation, progressivity and their relation to economic inequality. Although most African countries can be regarded overall as progressive, so aiding in income redistribution, they need to be made more progressive. Progressive income taxation generally results in higher revenues, less financial and economic volatility, and faster growth. The evidence also shows a link between higher tax revenues and a more equitable income distribution but it also suggests a link between higher tax revenues and larger deficits. Increased revenues tend to imply increased access to public services, and more revenue allocation towards poverty reduction efforts.

In countries with markedly unequal income distributions, more progressive taxation can translate into the generation of more stable, long-term financial resources and a greater ability of policymakers to engage in countercyclical fiscal policies. By taxing a larger proportion of income when the economy expands, a progressive tax tends to decrease demand when the economy is booming. This can help stabilize financial development and make economic growth more durable and boost domestic investment.

Progressive taxation can also indirectly affect economic growth in a positive way by reducing income inequality. Movement towards the equalization of after-tax income distribution helps the poor to afford basic necessities and afford improved standards of living, thereby underpinning growth. More progressive taxation can also improve the way in which an economy automatically stabilizes itself using the country's fiscal system i.e. its taxation and expenditure policies. A more equal income distribution can contribute to less output fluctuations. Specifically, a more equitable income distribution can help to stabilize domestic demand and thus reduce financial and economic volatility. As the output of an economy declines, incomes will also decline. However, the reduction in after-tax (net) income is disproportionately smaller than the reduction in before-tax (gross) income, which is due to the progressiveness of the personal income tax. Hence, more progressive taxes can directly help stabilize output fluctuations.

On the other hand, progressive taxation can impact negatively on human development by lowering the skill premium and thus discouraging skilled individuals to maintain and further develop their skills, especially where the cost



"The best things in life are free... And paying our taxes is what keeps us free..."

of education is high. It can also discourage unskilled workers from developing their skills.

The main challenges to achieving more progressive tax systems in most African countries lie in the areas of the taxation of wealth and property income and in how to bring the informal sector indirectly into the tax net. Tax systems that do not tax wealth and property income, and that do not have ways of indirectly taxing the informal sector to an adequate level, have a limited ability to achieve income redistribution. Such tax systems' ability to achieve social justice is curtailed as the additional revenue that could be used to provide social services is forfeited.

This calls for a need to evaluate all tax systems to determine the extent to which they are equitable and whether they can aide income distribution. Ensuring a more progressive tax system requires:

- that policymakers ensure that the tax policy structure imposes higher taxes on individuals with higher incomes as compared to those with lower incomes;
- that tax policy adequately captures within its net wealth, property income and the informal sector, so broadening the tax base;
- that reliable economic data be produced and made available to enable the measurement of tax equity indicators – especially how tax policy affects different groups of individuals – and to enable tax gathering analysis and tax expenditure analysis;
- that elected and civil leaders take a more active role in assessing tax issues, by clearly analysing any proposed changes in tax policy especially as presented in annual budgets, and also by pushing for reforms towards progressive tax systems;
- that civil society organizations provide an active link between the government and the citizenry by advocating for reforms that will ensure a more progressive

tax system, and also by creating awareness among the citizens with regard to issues of progressive taxation and its importance;

- that civil society works to reduce arbitrary political influence on tax policy matters, thereby supporting more democratic structures that promote progressive taxation;
- that the media disseminate information regarding tax policy changes and also create greater awareness on tax matters;
- that researchers in universities and research institutes support tax policy by engaging in research that will be used to guide tax policy and by engaging the government in tax policy matters;
- that the wealthy and well-to-do disclose their wealth to the tax authorities, as they are the ones who are most likely to have assets held in tax havens, and that they not engage in tax avoidance or tax evasion, which are against the national interest.

Endnotes

1 Bird, R., and Zolt, E., 'Redistribution via Taxation: The Limited Role of Personal Income Tax in Developing Countries', AYSPS International Studies Program Working Paper, Georgia State University, Andrew Young School of Policy Studies, Atlanta, 2005.

2 Bird, R., and Zolt, E., 'Redistribution via Taxation: The Limited Role of Personal Income Tax in Developing Countries', AYSPS International Studies Program Working Paper, Georgia State University, Andrew Young School of Policy Studies, Atlanta, 2005.

3 Schneider, F. and Klinglmair, R., 'Shadow Economies Around the World: What Do We Know?' Center for Research in Economics, Management and the Arts, Working Paper No. , 2004 – 03.

4 See the paper by Schneider and Klinglmair in the previous endnote.

5 Fuest, C and N. Riedel, 'Tax evasion, tax avoidance and tax expenditures in developing countries: A review of the literature' (a report prepared for the UK Department for International Development (DFID)), Oxford University Centre for Business Taxation, 2009.

6 Karingi, N., Wanjala B., Kamau A., Nyakang'o E., Mwangi A., Muhoro M. and Nyamunga J., 'Fiscal Architecture and Revenue Capacity in Kenya', KIPPRA DP No. 45, KIPPRA, Nairobi, 2004.

Further Reading

There is a large scholarly literature on the topics covered in this booklet. A good place to start would be with any of the articles referred to in the endnotes:

Bird, R., and Zolt, E., *'Redistribution via Taxation: The Limited Role of Personal Income Tax in Developing Countries'*, AYSPS International Studies Program Working Paper, Georgia State University, Andrew Young School of Policy Studies, Atlanta, 2005.

Cnossen, S, *'The Incidence of Consumption Taxes in Member Countries of the South African Development Community'*, a paper prepared for the Southern African Conference on Excise Taxation, Gauteng, South Africa, 2003.

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Weller, C.E, *'The Benefits of Progressive Taxation in Economic Development'*, Review of Radical Political Economics, Volume 39, No. 3, Summer 2007, pp. 368-376.

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Glossary

Countercyclical Policy: A policy that works against the cyclical tendencies of an economy. Countercyclical policies cool an economy down when it is in an upswing, and stimulate it when it is in a downturn.

Distortionary Effect of a Tax: The economic loss that a society suffers as the result of a tax, over and above the revenue it collects. Distortions occur mainly because people or firms change their behaviour in order to reduce the amount of tax that they must pay.

Excess Tax Burden: See *Distortionary Effect of a Tax*

Flat Tax: A tax system in which as income rises the amount of tax paid remains constant in proportion to total income. Compare with progressive taxes.

Income Tax: A direct tax that is imposed on income derived from business, employment, rent, dividends, interest, and pensions.

Informal economy: Those economic activities and the income derived from them that circumvent government regulation, taxation or observation. It includes unreported income from the production of legal goods and services, either from monetary or barter transactions, and so includes all economic activities that would generally be taxable were they reported to the tax authorities.

Non-tax revenues: Government revenues that are not generated from taxation, notably rents and royalties from extractive industries.

Personal Tax Relief: Uniform relief that is automatically granted to all those employed and all other personal income earners. The tax relief is deducted from the total tax payable of each individual taxpayer, thereby reducing the total amount of tax that an individual pays.

Presumptive Tax: Involves the use of indirect means to ascertain, or arrive at, a tax liability where the level of tax liability cannot – or cannot be easily –ascertained, for example, when taxing small-scale businesses and agriculture. The term 'presumptive' refers to the legal presumption that the taxpayer's income is not less than the amount that is approximated when completing a tax return.

Progressive Taxation: A tax system in which as income rises, the amount of tax paid increases in proportion to the income as well as in absolute amount i.e. the percentage tax rate increases as the income rises. Also referred to as graduation. Compare with flat and regressive taxes.

Regressive Taxation: A tax system in which as a person's income from all sources rises, the amount of tax they pay reduces in proportion to their income even if it increases in absolute amount i.e. their percentage tax rate falls as their income goes up. Compare with progressive taxes and flat taxes.

Shadow economy: See *Informal economy* above

Tax: A tax is any obligatory payment made to a state for which no direct benefit is provided in exchange, for example a payment based on a percentage of income earned from an employment is a tax. Conversely, the payment of a licence fee to a government, for example, to enable a person to use a car on the highway, is not a tax.

Tax Advocacy: The campaigning and information dissemination methods that civil society uses to represent the public interest in taxation, and to give a voice to those who currently have none in tax policy.

Tax Avoidance: The term given to the practice of seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud).The term is sometimes used to describe the practice of claiming allowances and reliefs clearly provided for in national tax law. It is, however, now generally agreed that this is not tax avoidance. If the law provides that no tax is due on a transaction then no tax can have been avoided by undertaking it. This practice is now generally seen as being tax compliant. So what the term tax avoidance now usually refers to is the practice of seeking to not pay tax contrary to the spirit of the law. This is also called aggressive tax avoidance.
Aggressive tax avoidance is the practice of seeking to minimise a tax bill by attempting to comply with the letter of the law whilst avoiding its purpose or spirit. It usually entails setting up artificial transactions or entities to re-characterise the nature, recipient or timing of payments. Where the entity is located, or the transaction routed through another country, it is international avoidance. Special, complex schemes are often created purely for this purpose. Since avoidance often entails concealment of information and it is hard to prove intention or deliberate deception, the dividing line between avoidance and evasion is often unclear, and depends on the standards of responsibility of the professionals and specialist tax

advisers. An avoidance scheme which is found to be invalid entails repayment of the taxes due plus penalties for lateness.

Tax Base: The amount or value upon which the assessment or determination of a tax liability is based. For example, the amount of income declared for tax purposes is the tax base for income tax. For excise taxes and VAT, the tax base is the ex-factory price of the commodity. Tax base can also refer to the range of assets and transactions that a country chooses to tax. A broad base includes a wide range of assets and transactions, a narrow base relatively few transactions.

Tax Burden: The amount of tax borne by an individual or company. This may not be the same as the tax actually paid because of the possibility of shifting tax to another individual or company.

Tax Deduction: Represents an expense incurred by a taxpayer, which is subtracted from gross income when the taxpayer computes his or her income taxes. As a result, the tax deduction will lower overall taxable income and thus lower the amount of tax paid. Examples of allowable deductions can be mortgage payments s and pension contributions.

Tax Effort: The proportion of tax revenue that is collected compared to the actual revenue potential. A high tax effort means that the government is able to collect most of its potential tax revenue. At the national level, the tax effort has a different meaning: it is tax revenues as a percentage of G.D.P. (Gross Domestic Product).

Tax Evasion: The illegal non-payment or under-payment of taxes, usually by making a false declaration or no declaration to tax authorities. It can include reporting expenses not legally allowed. Tax evasion entails criminal or civil legal penalties (in theory).

Tax Exemption: An exclusion from all or certain taxes with the result that part of the tax revenue that would normally be collected is foregone. Most basic goods are exempted from VAT (Value Added Tax) to make this tax less regressive.

Tax Expenditure: Any reduction in government revenue that results from applying a preferential treatment such as deductions and exemptions. It is therefore regarded as the cost to the state of tax exemptions or deductions.

Tax Gap: The difference between the amount of tax revenue that the government should be able to collect and the actual amount that is collected. The difference is mainly explained by tax evasion and tax avoidance.

Tax Holiday: A period during which a tax is not payable or is reduced. Governments usually create tax holidays as incentives for business investment. They are often designed to allow foreign companies to invest in a country and not pay tax for an initial period of years.

Tax Rebate: Also referred to as a tax refund, a tax rebate is a refund on taxes when the tax liability is less than the taxes paid.

Tax Subsidy: A form of financial assistance to an individual, business or economic sector, where the recipients receive the benefit through the tax system. It can be used to support businesses that might otherwise fail, or to encourage activities that would otherwise not take place. Examples include tax deductions or exemption from consumption taxes such as VAT (Value Added Tax).

Tax Threshold: The level of income above which income is taxable. Most countries put a threshold level in place in order to exclude low-income individuals from the tax net.

Withholding Tax: An income tax that is usually deducted at source from income payments made to individuals who do not directly pay income tax through the Pay As You Earn system. It is mainly levied on consultancy fees, dividends and interest income. The individual is expected to deduct this amount of tax from the total tax payable when filling in income tax returns. Withholding tax can also refer specifically to tax deducted from a payment made to a person outside the country; in this sense it tends to apply to investment income, such as interest, dividends, royalties and licence fees.

tax justice network - Africa

Tax Justice Network - Africa
Tigoni Rd. off Argwings Kodhek Rd. opp Yaya Centre
P. O. Box 25112-00100, Nairobi, Kenya
Tel: +254 20 2473373 Mobile: +254 728 279 368
Website: www.taxjustice4africa.net