actionaid

Tax justice: the domestic perspective

A synthesis of studies of the tax systems in five developing countries

Introduction

Why this report?

This report is part of ActionAid's ambitious project to debate, develop and propose strategies for development in a range of poor countries, from Nepal to Nigeria. These strategies aim to provide more equal and inclusive alternatives to those currently under official consideration, as well as a starting point for dialogue with decision-makers within the countries.

The tax system is a central pillar of any national development strategy, and in this report we describe and compare aspects of the tax system, and the tax issues coming up on the agenda, in five countries (Kenya, Tanzania, Nigeria, Cambodia and Nepal). The report will support the development of tax advocacy both within these countries and internationally.

Why domestic tax justice?

Tax is a crucial part of development and poverty reduction for at least four reasons:

- **Funding services**
  Tax revenues are the main source of funds for public services – schools, hospitals and clinics, roads, power and social protection.
- **Reducing inequality**
  Tax is a crucial instrument of income 'redistribution', both through financing services and development, and by ensuring that those who can afford to contribute more do so.
- **Accountability**
  Development of a sound tax system fosters accountability between citizens and government and thereby encourages better governance.
- **Self-determination**
  The more a country can rely on domestic resource mobilisation for the public revenue it needs, the less vulnerable it will be to conditions attached to development assistance, and the more the country will be able to choose its own development path. Autonomy in policy-making is at the heart of national development strategies.[1]

Because tax is so important for development, we need to look at how developing countries can both raise more revenue and do so equitably, through better tax systems – indeed through tax justice. ActionAid defines tax justice as "a transparent, accountable and efficient set of arrangements that raises substantial revenue for needed public services, development and government infrastructure through a broad tax base, with the proportionally largest contributions coming from those with the greatest wealth and income". This is the subject of this study.

Over the last few decades, most developing countries have reformed their tax policies along similar lines. First, they have attempted to broaden the base of personal income tax systems and reduce the highest marginal tax rates, in order to increase revenue and simplify the tax system; second, they have reduced corporate tax rates aiming to boost investment; and third, they have increased indirect taxes, such as VAT, to compensate for reduced trade taxes.[2] In addition, common administrative reforms have included the creation of specialist large taxpayer units and revenue authorities that are 'semi-autonomous' from government.

The results of these reforms have been modest. On average, low-income countries raise only around 15% of GDP in tax revenue,[3] compared with around 35% in high-income countries. However, increasing revenue is not simple or easy. If citizens do not trust the government to spend taxes wisely and fairly, there will be little support for taxation. In many developing countries, most people do not recognise the ways in which they are taxed, and where they do, taxation can be perceived as an unjust imposition on the payer. Furthermore, tax collection systems are poorly developed, and improving this requires sustained political backing.

There is a further major problem. Many of the potentially largest taxpayers – the wealthiest people and the multinational corporations – systematically minimise their tax contributions. Too many evade or avoid tax, sometimes through domestic means, and sometimes internationally by using tax havens. Companies also negotiate substantial tax breaks as the price of investment. The international community, through its laws and standards and emphasis on matters such as "improving the investment climate", tends tacitly to support rather than clamp down on such behaviour.

Tax and governance

The revenue benefits of developing the tax system are much more prominent in current debates than the benefits to accountability. Yet an essential dimension of development is the accountability of government to citizens; there is an accountability deficit in many developing countries that in both south and north is frequently cited as a key barrier to development.

The need to raise resources through taxation can in itself lead to the emergence of institutions of more competent, responsive and accountable governance. The need for the resources provides a strong incentive for the state to bargain and negotiate with the population to obtain them; and the state will have to put considerable organisational and political effort into doing so, which can have spill-over benefits in the form of a sustainable tax system.[4]

Research for domestic tax justice

ActionAid has campaigned for tax justice for several years, and so far has focused mainly on the international arena. This report redresses the balance towards the domestic, and looks at the tax systems in five developing countries – Cambodia, Kenya, Nepal, Nigeria and Tanzania. These countries are diverse. Cambodia experienced severe conflict up until a couple of decades ago and Nepal more recently; Nigeria is largely dependent on oil revenue. The report looks at how much tax is raised in each country, at the tax issues arising in the countries, and at priorities for change.

The information in the report is mainly based on five ActionAid national level reports and key stakeholder seminars, which debated national priority issues for tax justice advocacy. The ActionAid countries were selected on the basis of the priority their programmes had accorded to tax issues, as well as their suitability for inclusion in this comparative study. The main purpose of the research was for the participants to gain a clearer picture of the tax situation in their countries, and to share and debate the information gathered, rather than to provide a definitive analysis of each country.

The five reports, each commissioned by the respective national ActionAid offices in 2012, are as follows:

- Taxation in Cambodia: performance and policy, Ngo Sothath.
- The Kenyan tax regime: the architecture, incidence and gender biases of taxation in Kenya, Honest Prosper Ngowi.
- The architecture of the tax system in Tanzania, Honest Prosper Ngowi.
- Tax reforms in Nepal: an analysis from civil society perspectives, Keshab Khadka.
- Tax justice for national development: the case of the Nigerian tax system: Olusade Taiwo.

Despite its importance, tax as a development issue has been neglected until recently. But the radical imbalances in global taxation are at last becoming a subject of increasingly prominent debate. At both the global and national levels, the time is right for change.

Chapter 1

Who pays, how much?

An overview of tax structures

This chapter maps out basic tax information[5] for our five case study countries, comparing how much revenue is raised and how, and corresponding trends. This provides the basis for the analysis in the rest of the report.

Of our five countries, Nigeria is a special case because it raises a very high proportion of its revenue from oil. The incentive structure is therefore different, and comparison with the other four countries of parameters such as tax effort does not make sense. The Nigerian situation is therefore described in a section at the end of the chapter, rather than in the comparative sections.

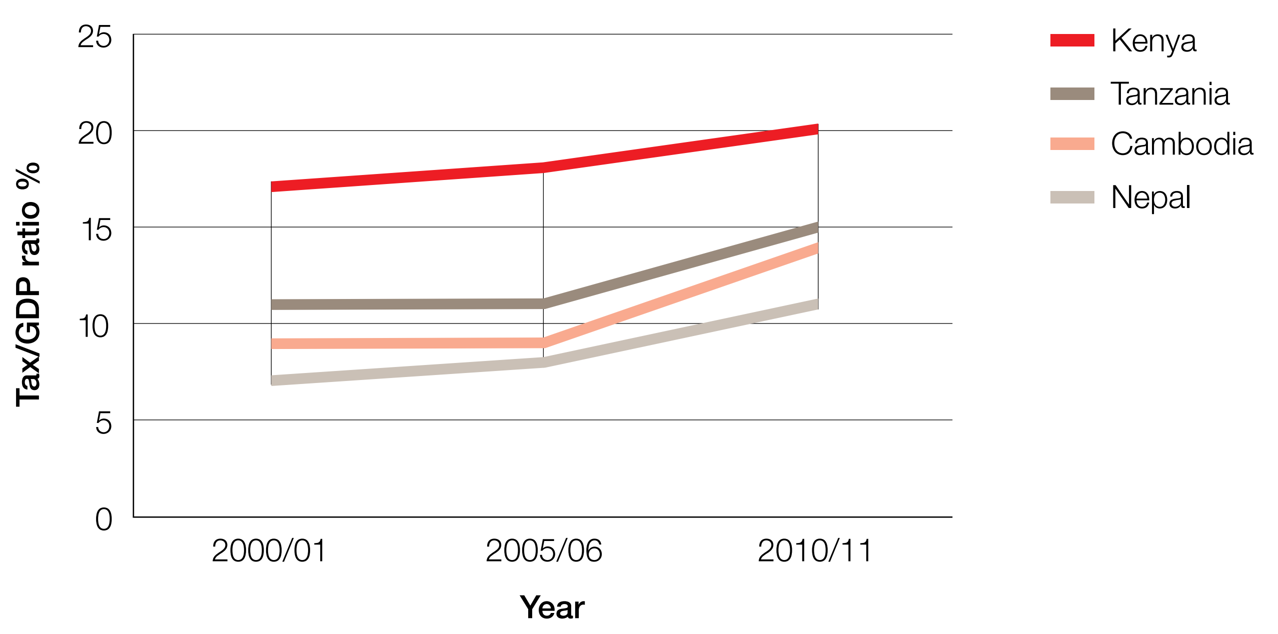
How much tax revenue?

The tax/GDP ratio shows the proportion of national income raised in tax revenue. It is an important measure, as it captures the overall effectiveness of the tax system, and the realisation of the development benefits of taxation. The United Nations Development Programme recently said that countries should aim to reach a tax/GDP ratio of 20% in order to meet the MDGs.[6] In 2007 the average tax/GDP ratio for all low-income countries[7] was just under 15%[8] ; in 2008 in sub Saharan Africa it was just over 17%, having increased by 4% since 2001.[9] In Asia in 2008 the average tax/GDP ratio was lower, at 10.4%.[10] In 2011, 20 of the poorest countries still had tax/GDP ratios below 20%.[11]

A low tax/GDP ratio may reflect weak tax administration, extensive tax incentives, low 'headline' tax rates, or high levels of tax avoidance. There may also be substantial non-tax sources of income.

Our countries vary around the 15% level, with the Asian countries slightly lower.[12] All the case study countries have increased their tax/GDP ratio by 3 to 5% over the last 10 years, a surprisingly uniform finding. This finding is reflected more generally.[13]

Trends in tax/GDP ratios



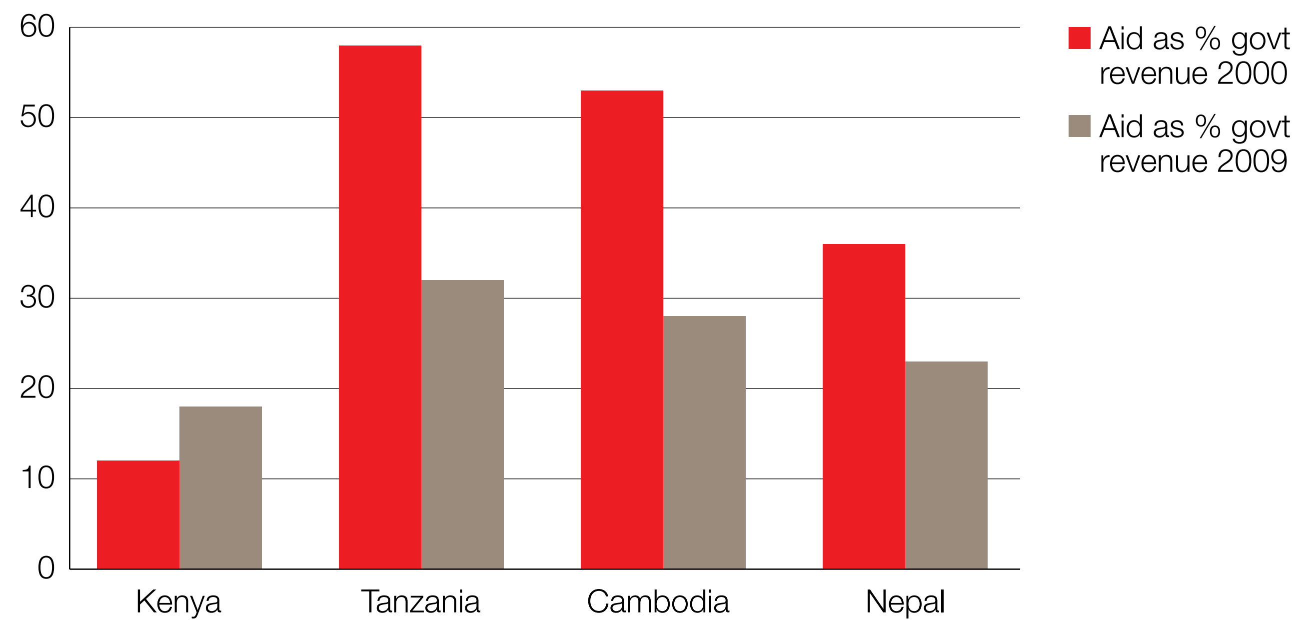
Ending aid dependency

Aid dependency is an important issue for many developing countries. This study's Kenya report voices a common sentiment, saying, "Higher levels of domestic resources through taxation stand to decrease countries' dependence on donors, and associated challenges such as conditionality and delayed inadequate disbursements of funds. With adequate tax revenues countries will have increased ability to formulate policies and strategies, and set and implement development priorities. The need for a country such as Kenya to continuously increase its efforts in domestic resource mobilisation to avoid excessive donor dependence cannot be overemphasised. This is especially so in the aftermath of the 2008 global financial and economic crisis, and an on-going Euro zone sovereign debt crisis characterised by economic austerity measures. The willingness and ability of donors to give more grants, let alone grants at previous levels, is highly questionable and not likely to stand the test of rough and turbulent economic times."

All the case study countries raise their own revenue for the majority of their public spending. Aid dependency has fallen dramatically over the last decade or so, even as absolute aid levels have risen, because many developing countries' economies have grown faster and therefore increased their revenue levels even without allowing for increased tax effort. Since 2000, aid dependency in low-income countries has fallen by an average of a third; low-income countries now depend on aid for about a third of their public spending.[14]

The proportions for the case study countries are as follows:[15]

Changes in aid dependency



Three of the four countries' aid dependency has decreased significantly over the last decade. Kenya's has increased slightly, because in the early part of the decade most donor funds to the country had been suspended following the IMF's 1997 embargo on aid to Kenya.

Who pays? Sources of tax revenue

A breakdown of tax revenue by source reveals where the tax burden falls, and how these relative proportions change over time.

Taxes can be paid by individuals or by companies. They can be levied in myriad ways. The most common are to tax income or profits, value added or sales, specific products (excises), imports and property or land.

Taxes can be organised into three main categories:

- Direct taxes – these are paid directly by the taxpayer to the exchequer; they cannot be passed directly on to others. They comprise mainly personal income tax (PIT) and corporate income tax (CIT).
- Indirect taxes – these are paid on economic transactions in a supply chain and can effectively be passed on; they are usually ultimately borne by the final consumer. They comprise mainly value added tax (VAT), sales taxes and excise taxes.
- Trade taxes – these are levies paid at a country's border on imports and sometimes exports. They comprise a special case of indirect taxation.

The economies of many low-income countries have been built on commodity exports, with a high ratio of exports to GDP, so trade taxes were an obvious source of revenue.[16] However, the policy trend in recent years has been to liberalise trade, therefore reducing trade taxes. Attempts have then been made to replace the revenue through other forms of indirect taxation, usually VAT, which over the last few decades has been introduced rapidly in a large number of low-income countries. This revenue replacement has had varying degrees of success.

As countries become wealthier, they usually increase the share of direct taxes in their tax mix. Low average income in poorer countries makes it difficult to raise significant revenue from personal income taxes. Moreover, direct taxes are politically more difficult to levy than indirect ones, because they are, in general, more visible. Governments in general prefer to levy taxes less rather than more visibly where they can.[17] Direct taxes tend to be levied more progressively than indirect ones – for further discussion of this issue see the next chapter.

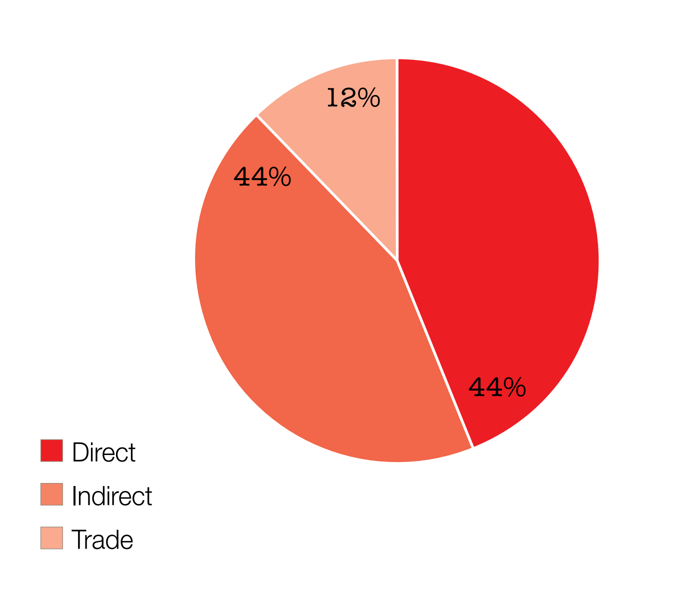
Some governments also raise significant amounts of revenue from natural resources. Between 1980 and 2005, resource-rich sub Saharan African countries increased their resource-related revenue as a proportion of GDP by 7%.[18] Some of this revenue will be tax revenue (for example Nigeria's petroleum profits tax) and some non-tax (for example government revenue directly from oil or mineral sales). Countries may also obtain non-tax revenue from other state owned enterprises. Thus just half of Nigeria's government revenues are tax revenues, compared with the other case study countries' 80-90%; and some of Nigeria's tax revenue itself derives from its natural resources via a petroleum profits tax.

"Taxation is key to increasing our legitimacy and ability to make our own decisions."
Mary Baine, Commissioner General, Rwanda Revenue Service[3]

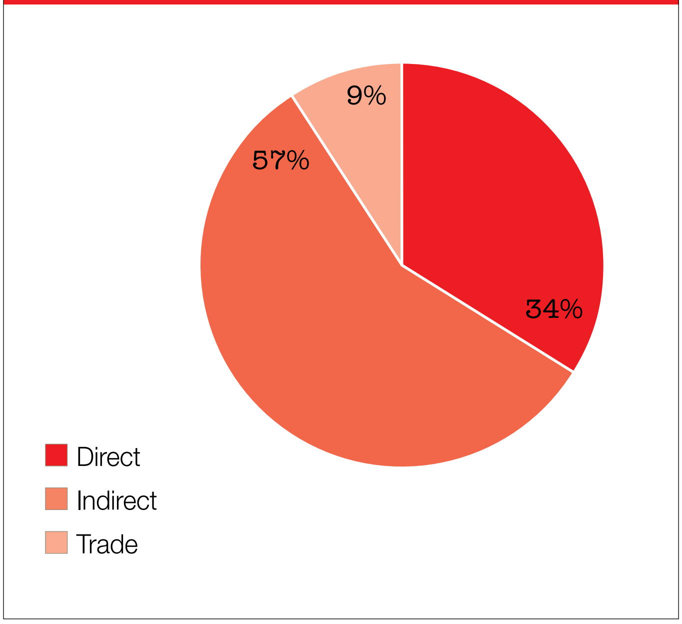
Who pays? snapshot

The proportions of direct, indirect and trade taxes for our case study countries break down as follows:

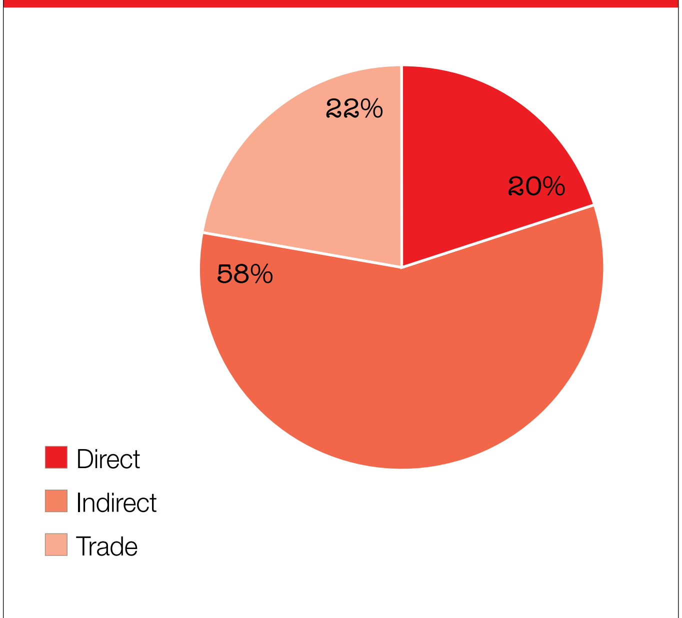
Kenya 2010/11



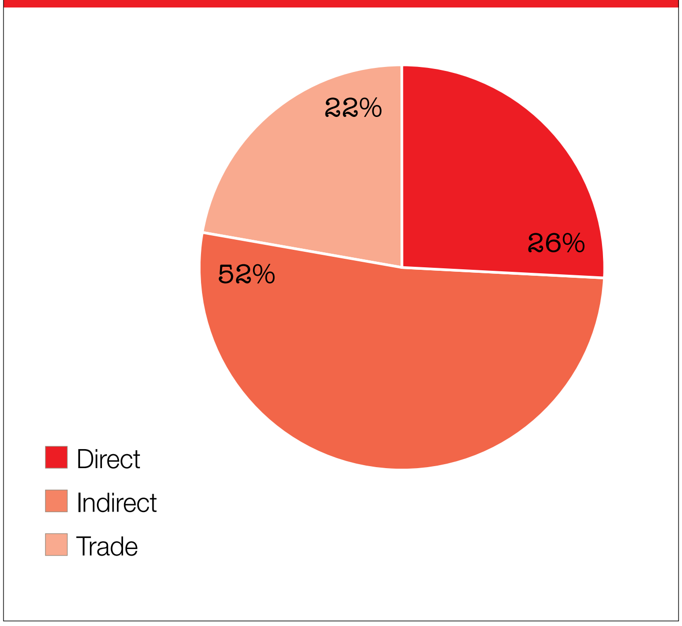
Tanzania 2009/10



Cambodia 2010



Nepal 2010

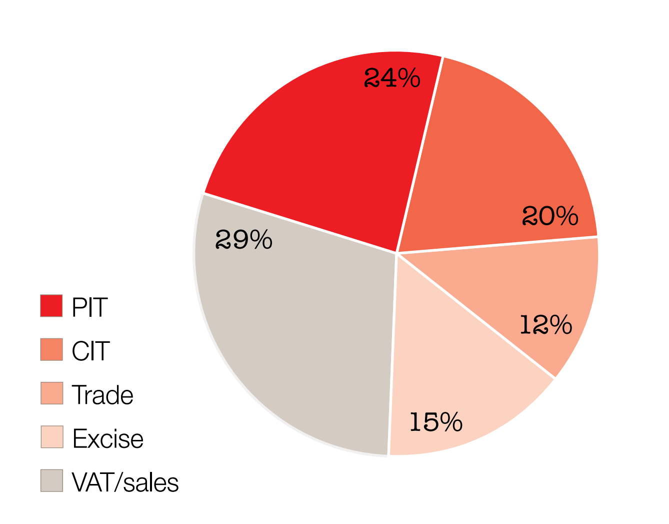


Indirect taxes comprise a significantly higher proportion of revenue than direct taxes in Cambodia, Tanzania and Nepal. The reverse is true in most developed countries.

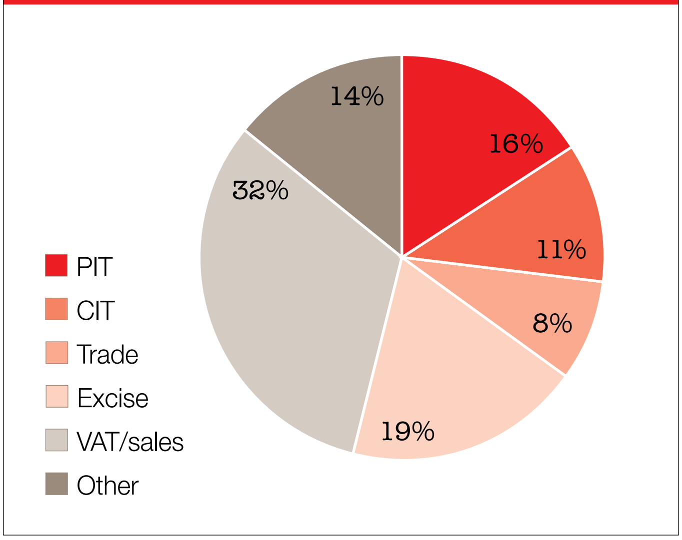
Our African countries collect more direct tax than the Asian, and much less trade tax (which could either be because trade liberalisation is more advanced in Africa or because these particular Asian countries trade less in the first place). Kenya has a notably lower proportion of indirect tax than the others, and is the only country with equal proportions of direct and indirect taxation.

These categories can be broken down further into different tax types:

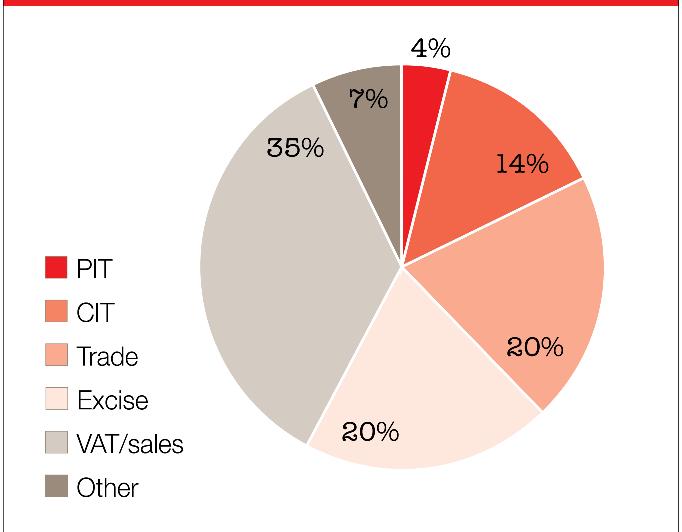
Kenya 2010/11



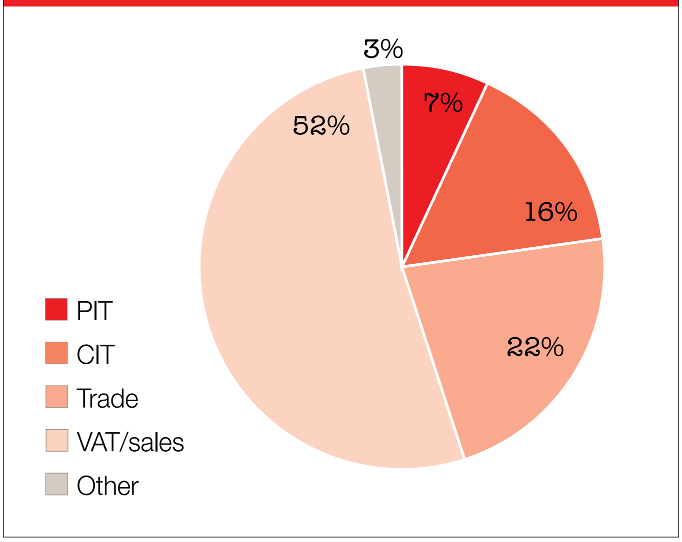
Tanzania 2009/10



Cambodia 2009



Nepal 2009



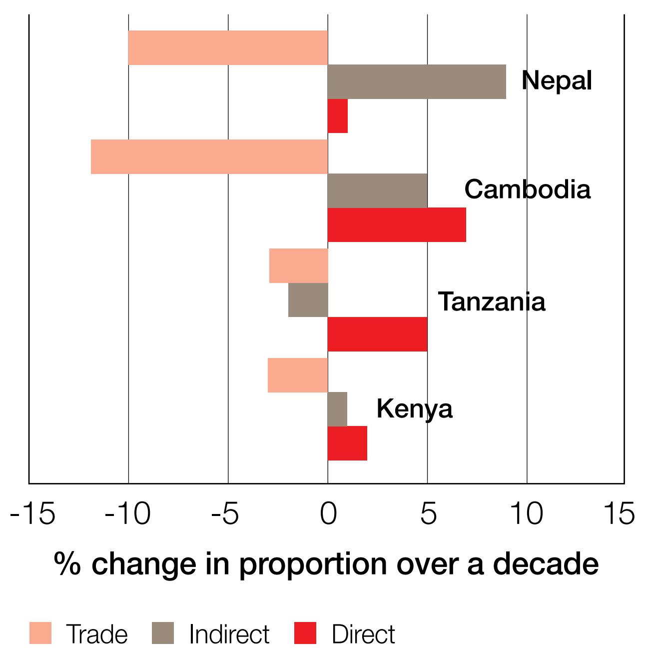
In this detailed breakdown there is no consistent additional pattern across all countries. The African countries levy a far higher proportion of PIT than the Asian, with Kenya far ahead of Tanzania. The proportions are broadly similar between all countries for CIT, with Kenya somewhat ahead and Tanzania behind. Each Asian country therefore levies a much higher proportion of CIT than PIT, with the reverse being true for the African countries.

The breakdown within indirect taxes is similar for each country, the excise proportion being about half that of VAT.

Who pays? Trends over time

As tax effort increases and tax policy evolves, the proportions of the different types of tax change. For the case study countries these changes have been as follows:[19]

Changes in direct indirect & trade tax proportions over a decade



Over the last decade the proportion of direct taxes has increased in all our countries, while the proportion of trade taxes has fallen. This fall is much greater in the Asian countries than the African, although levels of trade tax are still higher in the Asian countries. Indirect taxes have increased significantly in the Asian countries (commensurate with the fall in trade taxes); in the African countries they have remained flatter, even falling slightly in Tanzania.

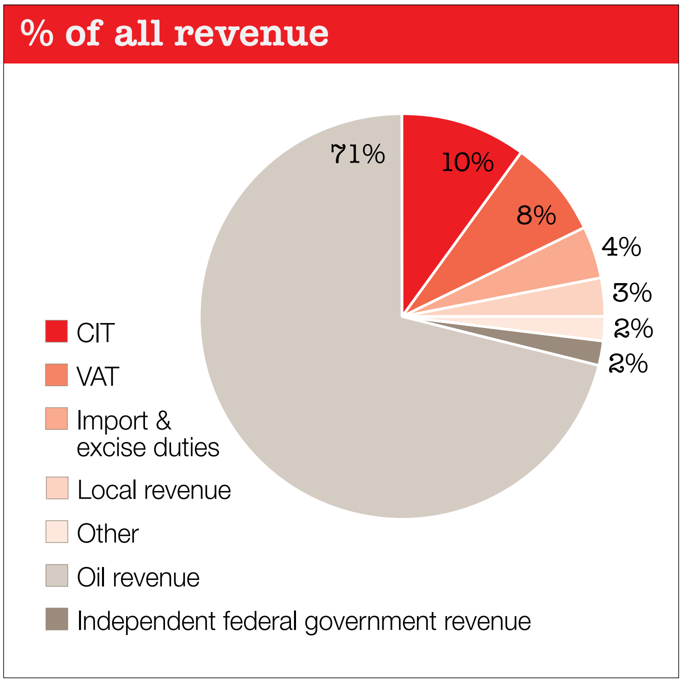
Direct taxes have therefore increased more than indirect in all the countries except one (Nepal). Whilst over recent decades attention has tended to focus on trade tax replacing indirect tax increases, the increasing proportion of direct tax is not a surprising finding, as historical evidence shows us that proportions of direct taxation generally do increase as a country's national income increases. It is often because the proportion of revenue from personal income tax can increase, as more people earn wages over the tax threshold.

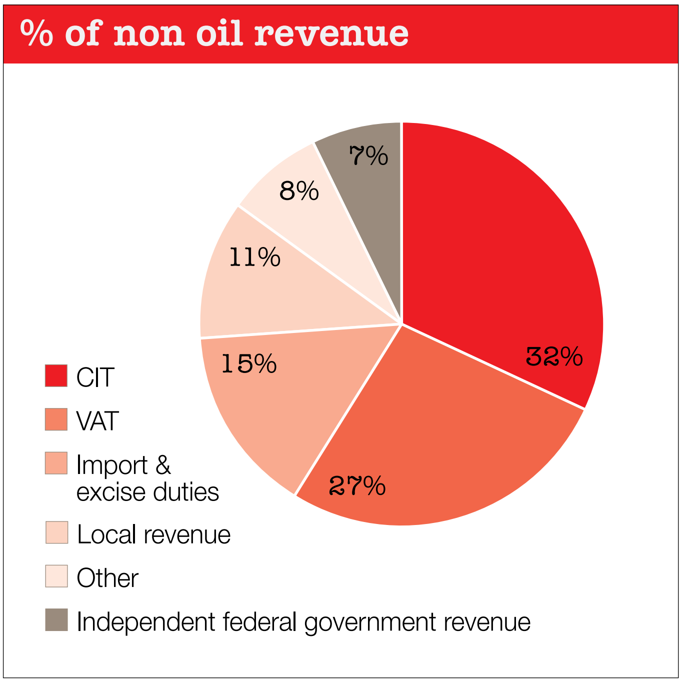
As a general comparison, the last decade or so has seen the proportion of direct taxes increase slightly (by 2%) in sub Saharan Africa as a whole, and the proportion of indirect tax has decreased by a similar amount. Not surprisingly given trade liberalisation, the proportion of trade taxes has also decreased, but only by about 2%.[20]

The special case of Nigeria

Nigeria is excluded from the comparative analysis because its dependence on oil and gas revenue makes direct comparison to the other four countries difficult.

Approximately 50% of Nigeria's government revenues are derived from non-tax sources: principally sales and royalties from oil and gas. A substantial portion of tax revenues also comes from a petroleum profit tax, so overall 70% of Nigeria's revenue (tax and non-tax) is derived from oil and gas. The non-tax proportion is unusually high, and the dependency on oil and gas extraction as a source of both tax and





non-tax revenues is also clearly high. Year on year, revenue levels fluctuate as a result not of increases in tax effort, but fluctuating oil prices.

Nigeria's tax system is complex, with a three-tiered fiscal federalism (federal, state and local); all revenue is pooled and distributed at all levels. Authorities have made many attempts to manage the oil and gas revenues. There is now a sovereign wealth fund (SWF) into which revenues above the spending budget are paid; this has a strong legal foundation that makes it difficult to make inappropriate withdrawals. The SWF includes a stabilisation fund, an intergenerational fund and an infrastructure fund.

Non-oil and gas revenue is sourced as follows (charts above)[21]

It is thus apparent that the concept of personal income tax is at a nascent stage in Nigeria; probably it has not been necessary to tax personal income because oil revenue has been available.

Conclusion

Our four 'typical' case study low-income countries are taxing more than 10 years ago, they are depending less on aid, and more of their tax is direct tax.

These countries have been increasing their tax/GDP ratios, in line with the general trend. The Asian countries ratios are lower than the African ones. All these countries have much higher proportions of indirect to direct taxation as a proportion of national revenue, apart from Kenya where they are equal. Nevertheless, the general trend is that direct taxes as a proportion of revenue are increasing, while indirect taxes are also increasing but to a lesser extent, and trade taxes decrease. The exception is Nepal, which has seen a large increase in the proportion of indirect tax. Of the direct taxes, our African countries levy a higher proportion of PIT and our Asian CIT. Overall, there is a long way to go, but the trends in revenue mobilisation in our developing countries are generally positive. There is a good base on which to build progress.

Tukura Albert Samuel, Teacher at Yangoji Junior High School in the village of Yangoji, Abuja State, Nigeria, teaches Science and Technology to a class of girls.

PHOTO: Kate Holt/Shoot The Earth/ActionAid

Lack of goverment funding to support vital resourses, Nigeria.

Tukura Albert Samuel won Teacher of the Year in Nigeria in 2012. He teaches Science and Technology at Yangoji Junior High School in Abuja state. He faces multiple problems, he says, including large class sizes, lack of facilities (the teachers sometimes end up buying teaching materials out of their own money) low pay and corruption.

Tukura has to grow food on the weekends to survive, because his pay is not enough. He has also been the victim of corruption several times. For instance, his file of qualification certificates and evidence of past jobs went missing (he believes someone took it) so he had to begin working his way up the grade system again. Another time he won a place in a competition in Peru, but a board member took his place.

"The education system in Nigeria is collapsing around us. There are no amenities and the school structures are not being repaired. There is a general drop in standards and the quality of the teachers is nothing like it used to be." Public funding for education in Nigeria is inadequate, despite significant government revenues – directly and indirectly – from Nigeria's huge oil and gas reserves. Tax justice needs to be part of larger fiscal justice, encompassing both revenue raising and public spending that benefit poor people.

Chapter 2

Progressive tax, progressively spent?

Well managed public spending has the potential to address poverty and inequality by providing a range of essential public services for all. For example, a universal education system improves the life chances of everyone in society. However, this is only part of the potential of tax to address inequality. Tax can be levied in different ways. If those with more income or wealth, and therefore a greater ability to pay, pay a higher proportion of their income in tax, the system is progressive – and addresses income inequality directly. If the same percentage of total income is paid in tax regardless of ability to pay, the system is called proportional. If the proportion of income paid increases as income decreases, the tax is regressive, and the tax side of the tax-and-spend equation exacerbates inequality directly. This section of the report deals with the potential of tax to address inequality.

In general, direct taxes tend to be more progressive and indirect taxes (VAT, excise taxes) less so. However, the situation is much more complicated than this. Personal income taxes with a progressive structure, and taxes on corporate income, are likely to be progressive, but this may not be so if, for example, the tax falls predominantly on a middle income group and the wealthiest are able to avoid or evade it. Conversely, whilst VAT is sometimes levied at a flat rate, a well-thought-out system of zero-rating targeting poor people may result in it being proportionate or progressive.

Empirical analysis of progressiveness of tax is difficult, because tax burdens ultimately fall on different groups of stakeholders in a complex fashion; the analysis that does exist is often controversial. Our comments here are of a general nature.

Progressive taxes?

Indirect taxes - value added tax (VAT)

VAT is often thought to be a regressive tax, because it is levied on products at the same rate whatever the income of the purchaser. The poorest households are generally not eligible for PIT because their income falls below the PIT threshold, but they do pay VAT on products they buy. However, VAT may or may not be regressive; many countries have systems of exemptions and zero ratings on essential products, mitigating the impact of VAT on the poorest people. The impact of these systems can be complex.

The situation in Kenya provides an example of this complexity.[22] Kenyan VAT is slightly regressive, with households in the lowest expenditure quintile (that is, the fifth of households who spend the least) paying a higher proportion of their expenditure in VAT than the next quintile. This is the case despite the Kenyan system of VAT exemptions and zero ratings on some food items.[23] However, urban households pay more VAT as a proportion of their expenditure on non-food items than their rural counterparts. On average urban households are better off than rural ones, so for non-food, VAT is progressive in a rural-urban dimension. This may be because urban households spend a higher proportion of their income overall on non-food items than those in rural areas. VAT also has differential gender implications in Kenya; these are examined in chapter 3.

However, owing to the exemption and zero rating system for some essential items, Kenyan VAT is not as regressive as it would be otherwise. The Kenyan list includes a wide range of food and other essential items, as well as some exemptions aimed at business, finance and defence. The reasoning for the former set of exemptions, although clearly not the latter, is likely to be protection of the poorest people.

The current proposed Kenyan VAT Bill[24] may remove some of the exemption and zero-rating cushions, including from processed milk, rice, bread, wheat flour, maize flour, fertilisers and fuel (LPG). Poor people, with a high proportion of expenditure on these items, will therefore bear a much higher tax burden than currently if this Bill becomes law.

"While raising higher levels of domestic resources is important, it is equally important that it is done in a just and fair way."
Kenya report

Zero-rated goods and services	All goods and services for export, maize (corn) flour, wheat flour, vaccines for human and veterinary medicine, first aid boxes and kits, kerosene, mosquito coils, sanitary towels and tampons, exercise books, dictionaries, journals, newspapers, contact lenses.
Exempt goods and services	Most live animals, most foods, petroleum oils, charcoal, cellular phones, wooden coffins, military weapons, most financial and insurance services, agricultural, medical and veterinary services, rental and leasing of land and residential buildings, entertainment services by artists resident in Kenya.

Source: Tax Justice Network Africa, VAT fact sheet

Cambodia also has a VAT system with some zero-rating and exemptions, as does Nepal. In Nepal, urban essential items appear to be prioritised for exemption over rural. Petroleum products in general have concessions while those on chemical fertilisers have been withdrawn. This leads to a suspicion that, "the present tax regime is benefiting the elites at the cost of marginalised silent masses",[25] an important general point about the importance of political power in gaining tax concessions.

Indirect taxes – excise taxes

Excise taxes are "sin taxes" on alcohol and tabacco, for example. They are mainly levied at relatively high rates on just a few commodities, at the border or at point of sale.[26] It is intended that the burden of excise taxes falls mainly on those in the middle and upper income brackets, whose demand (in theory) is less responsive than that of the lower income brackets (in other words, as prices increase due to the tax, the better off may keep consuming at the same rate). If the middle and upper income brackets do indeed pay a higher proportion of their income in excise taxes than lower income brackets, then the tax is progressive.

However, where alcohol and tobacco are concerned it is possible this does not occur, and that the incidence falls on lower income groups too (their demand for these commodities may actually be fairly price inelastic). If this is the case, excise taxes could be proportionate or regressive.

Direct taxes – corporate income tax

In developing countries corporate income tax often represents a high proportion of taxation from a small number of taxpayers: the largest companies. It is therefore an important tax from a revenue-raising perspective, because there is a high revenue gain for a relatively small administrative effort (albeit potentially a large political one).

The progressiveness or otherwise of corporate income tax is one that is hard to confirm empirically; it is often hard fought politically, with passionate advocates on both sides of the debate. Most estimates that exist, of where the corporate tax burden falls, analyse it within a single (wealthy) country. However, in the case of northern-based multinational companies investing in developing countries, at least part of the tax incidence will ultimately fall on the company's shareholders; this signals that progressiveness is likely.

However, large companies often do not fulfil their potential, or even their obligations, as taxpayers. They frequently negotiate tax exemptions, and often avoid the taxes that are due. Both these issues are covered in more detail in later chapters.

Direct taxes – personal income tax

Personal income taxes are usually progressive, because they are often levied at higher rates on people with higher income levels. However, they are a fairly recent development in most developing countries (due to low incomes and a historical preference for increases in indirect taxation rather than direct), and they currently provide a relatively small (although growing) proportion of revenue.

Of our case study countries, Kenya has a relatively high proportion of personal income tax at 24% of revenue. However, the progressiveness of Kenyan PIT could be increased. The minimum threshold is Ksh1,162 (Kenyan shillings) – about US$14 – per month and above this the tax progresses (with five tax brackets) up to a relatively low income level of Ksh 38,893 (about US$470) per month.[27] Above this maximum threshold, income tax is charged at a rate of 30%, up to the very highest incomes. Therefore a millionaire pays the same marginal tax rate as someone earning US$470 a month. This low progressiveness has been debated in the Kenyan press.[28] Tax bands have been fixed since 2005, but since then there has been high inflation, so while incomes have risen absolute tax thresholds have stayed constant.

In Tanzania, the minimum personal income tax threshold is much higher, at Tsh135,000 (Tanzanian shillings) – about US$84 – per month, with a similar top tax rate to Kenya's of Tsh720,000 (US$450) per month. As in Kenya there are five tax brackets and the top rate is 30%.[29]

Cambodia's threshold is even higher at 500,000 riels (about US$125) per month, with again five tax brackets, and a much higher top bracket at 12,500,000 riels (US$3,125) per month, but a top tax rate of only 20%. In Nepal, the top rate of personal income tax is much higher at 40%.[30]

Direct taxes – capital gains tax

Potentially another important and progressive tax, this is only mentioned in our report on Kenya, and in the context of its absence there. Kenyan capital gains tax was suspended in 1985 at the height of public land-grabbing,[31] and an attempt to reintroduce it in 2006/07 was rejected by parliament.[32] Kenya may be foregoing substantial tax revenue due to its lack of effective capital gains taxation. For example, Kenya Revenue Authority reportedly lost out on an estimated revenue of US$ 83 million from Airtel's takeover of mobile phone network Zain Africa in 2010.[33]

Direct taxes – property tax

Property taxes currently provide a relatively small amount of revenue. For example, in Cambodia a land and property tax raises 1% of tax revenue. Property taxes could potentially be progressive in developing countries, as property owners and dealers tend to number amongst the wealthy and poor people very rarely own taxable property. However this is not a foregone conclusion as the tax may be borne by tenants who are often less wealthy. Whilst property taxes may be politically difficult to introduce (because they are likely to impact on the richest and most powerful) other taxes may be even harder; for example in Kenya a property tax was introduced at the same time as the attempt to reinstate capital gains tax failed. A Kenyan tax on rental income has also recently been announced; this is unlikely to be progressive.[34]

A Cambodian property tax is the country's most recent tax innovation, introduced in 2010.[35] It contributes to regional rather than national budgets, and is levied on land and property associated with the land. Perhaps providing an illustrative example of the interesting negotiations surrounding tax the world over, swimming pools are exempt.[36]

Tax and the informal sector

The informal sector – the part of the economy that is not registered with official bodies – is a large proportion of the economy in developing countries, estimated to comprise 40% of GDP on average and up to 60% in some countries.[37]

For example, in Kenya the informal sector occupies

70-80% of the labour force, and grew by about a third in the four years to 2006.[38] Tax evasion by the informal sector is, almost by definition, particularly high, because informal businesses do not fill in tax returns.

The informal sector in Tanzania accounts for about 40% of GDP according to one study.[39] Revenue lost from not taxing the informal sector could therefore be equivalent to between 35-55% of the total tax revenue.[40] Other studies estimate that the informal sector accounts for around 70% of the country's workforce.[41]

In Cambodia, estimates (although from some time ago) are even higher; in 2003 the informal sector may have accounted for 62% of GDP, although with a falling trend.[42]

In Nigeria, the Federal Inland Revenue Service (FIRS) census of all potential business and public sector taxpayers found that only 14.8% of respondents nationwide had registered with the FIRS.

The 'informal sector' is also extremely heterodox, encompassing not only micro-businesses and small traders but also much larger businesses from construction to small manufacturing, and wealthy professionals like lawyers and accountants. The enforcement and social costs of taxing small, poor individuals or businesses may well outweigh the revenue benefits; but significant revenues may well be achieved by taxing larger informal businesses and high-earning professionals.

Progressively spent?

Fiscal approaches to reducing poverty and inequality need to consider expenditure as well as revenue-raising. Tax systems can reduce inequality in two ways: by taxing in a progressive fashion, and by spending the resulting revenue on services that benefit poor and excluded people. The expenditure side is also particularly important as part of taxpayer education. Where citizens can see the benefits of improved public services, they are more likely to support the taxation that finances those services.

In some countries the path to this is not smooth. For example, in Nigeria, recurrent public expenditure (spending that arises year on year, comprising mainly salaries for public sector workers) accounted for 74% of the budget in 2011. Although this was down from 80% in 2003, it is evidence that a high proportion of the budget is not reaching the poorest people, or even the vast majority of citizens and is not being invested in capital expenditure for development. The Kenya report alludes to a similar issue, saying: "There is certainly room to cut wasteful spending and reduce the wage bill for government." However, it is worth remembering that government workers are also needed to implement development programmes and essential services (and their numbers were cut extensively during structural adjustment), and that salaried staff contribute to the economy through the money they spend.

Beyond this, the Nigeria report carried allegations of corruption. A civil servant interviewed for the study said, "public resources are being carted away by a few public officials and their cronies through institutionalised graft and waste." There has also been a highly publicised corruption scandal in Tanzania over the last year, and reported instances of misspending, for example in the health sector on vehicle technology rather than medicines and beds for clinics and hospitals. Indeed, corruption is a major public concern in each of the countries surveyed. One of the many long-term benefits of building a fair and comprehensive tax system is the building of the social contract that will help tackle problems with corruption and misplaced priorities, because this process will necessarily involve the state bargaining with citizens, greater transparency, and the building of more sustainable institutions.

Spending on essential services

To ensure that public spending of tax revenue contributes adequately to poverty and inequality reduction, it is necessary first to ensure that an adequate proportion of revenue is spent on essential services. International commitments to this end have been made. For example, in 2001, under the auspices of the African Union, African governments pledged to spend 15% of their budgets on improving their health systems. However these commitments have not been realised in all countries. For example, in Nigeria, budget allocations for education and health are below recommended international standards. Spending on education as a share of the budget actually decreased between 2005 and 2010, from 7% to 5% (although the share going to 'social and community services' increased). In Nepal, spending on health and education as a proportion of GDP is increasing slightly – but still not making a dent in inequality, which the Nepal report attributes to the small absolute size of the overall budget. In Tanzania, the under-resourcing of public goods and services has been highlighted by recent strikes; there have been several strikes by university students, lecturers and doctors. However, Tanzania's Five Year Development Plan shows recognition of the need to increase revenues and spending on essential services.

The big picture – poverty and inequality

The raising and spending of revenue is one important factor in reducing poverty and inequality in developing countries.

There are various measures showing poverty and inequality in our case study countries. In Nigeria, poverty has increased over the last decade, with 69% of people below the national poverty line in 2010. Income inequality has also increased: the Gini coefficient (a measure of inequality) rose from 0.429 in 2004 to 0.447 in 2010.[43] Thirty-six percent of Tanzanians were in the mid-2000s living below the poverty line.[44] Inequality in Cambodia is also increasing, from 0.35 in 1994 to 0.43 in 2007; this

Jalena Mohamed, 50, and Hawa Amiry, 41 pictured in Miyuyu Primary School, Miyuyu village, Tanzania.

PHOTO: Andrew McConnell/Panos Pictures/ActionAid

Community budget tracking in Tanzania - the need for accountability in public spending

Boosting government's tax revenues must go hand in hand with accountability for public spending. Individuals and companies are more likely to be tax-compliant if they can have confidence that revenues will be spent for the benefit of all.

This is true at the community level too, where scrutinising spending at the local level can have a big impact on the community and their confidence to have a stake in their own development.

Jalena and Hawa have been trained by ActionAid as community development facilitators – this allows them to share knowledge with and educate their community about planning, budgeting and tracking expenditure. Jalena is a school committee member and is involved in making sure the school is being run well. Hawa is involved in planning and finance within the community.

increase is concentrated in rural areas.[45] In Nepal, inequality also increased, from 0.31 in 1990 to 0.46 in 2006 and 0.47 in 2010.

Of course, reducing poverty and inequality is complex, and relates to many factors beyond tax. The Cambodia report points out, "We don't have the firm evidence to show what the impact of tax is on inequality. It is possible that lower inequality in Phnom Penh is explained by effective taxing whereby higher income groups may pay a progressive salary tax as well as consume taxed goods and services. However, this could also be explained by the fact that lower income groups in Phnom Penh benefit from improved economic opportunities proportionally more than the higher income groups."

Conclusions

Direct taxes tend in general to be more progressive than indirect ones, and direct taxes are generally taking an increasing share of both revenue and GDP. This is a positive trend. The complexity of this issue means, however, that analysis of the distribution of both the tax burden and the resulting public spending is important as a basis for discussion of changes in fiscal policy and its progressiveness. Such analysis is rarer within governments than it should be.

For ActionAid, the main importance of indirect taxes is that they are the taxes that reach the poorest households. Many countries have a system of exemptions and zero ratings for essential items such as some food and fuel; while this may not actually make the taxes progressive, it does make them less regressive. It is important to install and maintain pro-poor exemption systems.

There is potential to increase the more progressive direct taxes further. Corporate income tax could be increased by tackling exemptions and avoidance – the subject of chapter 4. Personal income tax could be made more progressive in some countries – notably Kenya – by reviewing and updating tax brackets. A careful look at the informal sector could also broaden the tax base and increase progressiveness, but this needs to be done with care, ensuring the poorest and most vulnerable people are not targeted.

Other direct taxes, such as capital gains taxes and property taxes, are underused in some developing countries and could be further explored.

Progressive spending is the counterpart to progressive taxation in reducing poverty and inequality. To this end, spending on essential services needs to be adequate, and countries need to tackle any waste in public spending. Improving the tax system will help in itself, as it will help forge a transparent social contract between government and citizens.

The main conclusion from discussions of the progressiveness of different types of tax, however, is that we need detailed analysis of individual countries' situations; the situation is complex and one size does not fit all.

Chapter 3

Gender and tax

The previous chapter focused on inequality between rich and poor; here we focus on inequality between women and men. This dimension of inequality is crucial for development, as the majority of poor people are women.

The ActionAid Kenya report focused on gender more than the others, so most of the illustrative examples in this chapter are Kenyan.

Tax and gender in general

Women and men are affected differently by the tax system, in two main ways. Firstly, in women's continuing role as homemaker, public services are more important to poor women than to poor men. If health or education services are inadequate, it is women who will (as unpaid carers and homemakers) fill the gap.[46] Adequate financing of public services is essential for poor women.

The other way is through the tax system itself. Sometimes women and men pay different amounts of tax, either because of tax filing arrangements for personal income tax, differentials between the genders in levels of formal employment, or because the burden of indirect taxation falls on products that one or other gender purchases disproportionately. For example, VAT is often biased against poor women who spend a larger proportion of their incomes on basic goods to feed and clothe dependents than men. Excise taxes may fall more on men than women, if men consume a greater amount of taxed items such as alcohol and cigarettes.

In general, governments need to commit to incorporating a gender perspective in budgetary processes. In addition, women's as well as men's participation in public discussion on budgets is important.

Gender revenue analysis can include any or all of the following:

i) Introduce, support and expand existing efforts to improve the collection of sex-disaggregated data.

ii) Review tax law, to identify explicit bias and formulate recommendations for change.

iii) Support research on the gender equity improvements that could be attained if the tax system were made more progressive, looking at distributional consequences and administrative aspects of both personal income tax and corporate income tax.

The issue of whether tax systems treat women and men differently is a subject that has received abundant recent attention.[47]

VAT and gender

A major recent study in Kenya on VAT and gender looked at differences in proportion of income paid in VAT in households headed by women and those headed by men.[48] They found that the VAT burden was slightly higher overall in male-headed households, especially in urban areas. However if the zero-ratings and exemptions were removed, it would be higher in female-headed households, especially those which did not own any land. This may be because women (especially those without land) spend a higher proportion of their income on basic food items; 80% of food consumption is VAT exempt or zero rated. Women thus benefit proportionately more than men from the exemption system – a positive outcome from a gender perspective.

The reverse was true for non food purchases in urban areas – male-headed households benefit more from exemptions of non-food items than female-headed ones. Less than 10% of non-food is exempt from VAT, so the exemption system must favour items that men spend a higher proportion of their income on.[49]

Thus, current Kenyan food item VAT taxation is neutral or slightly progressive, whilst VAT taxation of non food items is regressive, from a gender perspective.

The proposed Kenyan VAT Bill seeks to remove many exemptions and zero ratings in the VAT system,

> " …tax policy is biased against women because it tends to increase the incidence of taxation of the poorest women while failing to generate enough revenue to fund the programmes needed to improve these women's lives."
> Tax Justice Network Africa

including on energy and basic food commodities. The strides made so far in ensuring poor women benefit from the VAT system are thus in jeopardy.

In Nepal, a similar situation prevails. Staple items are VAT exempt, which benefits women as they spend a higher proportion of their income on these items than men.

Excise taxes and gender

Kenyan excise taxes are levied mainly on alcohol and tobacco. These fall mostly on men due to gender differences in consumption of these products. In as much as the excise tax is intended to deter overconsumption of the products, this is not problematic. However it may be highly regressive if the products are price inelastic for men in the lower income quintiles.

PIT system treatment of women and men

Changes have been made to the personal income tax system in Kenya so that it treats men and women equally, with each person being assessed individually for tax due, rather than assessment being made of married couples. This provides an incentive for women to increase their earnings. If a woman's income is added to that of her husband for tax purposes, the couple may reach a higher tax bracket and therefore the woman will effectively pay more tax than she would under an individual filing system.

Gender responsive budgeting

Nepal provides an example of gender responsive budgeting. The government assesses and publishes the gender responsive proportion of the budget (as well as the pro-poor proportion).

Items that count towards the pro-poor budget include: investment in the rural sector, social mobilisation, health, education, social security, grants for local bodies and expenditure focusing on poverty reduction. Gender-responsive items include: women's share in benefit of programmes, support for employment and income generation for women, and minimisation of women's workload.

Conclusion

Both taxing and spending can have differential gender implications. It is particularly important to ensure tax that the poorest people pay – that is, VAT – is subject to gender analysis. VAT without exemptions is likely to be regressive between women and men because women tend to buy more family essentials; a good exemption system may reverse this.

Essential services are particularly important to women, as they are the ones who will fill the gaps where these services do not exist. This and other aspects of gender analysis can be accounted for by gender-sensitive budgeting.

Fiscal year	Pro-poor amount	Pro-poor %	Gender responsive amount	Gender responsive %	Total amount
2007/08	51,189,024	30.29	751,294,040	44.46	168,995,600
2008/09	95,776,515	40.58	116,486,951	49.35	236,015,897
2009/10	132,028,445	46.18	153,614,408	53.73	285,930,000
2010/11	158,334,045	46.86	183,256,148	54.24	337,900,000
2011/12	186,630,733	48.49	249,546,572	64.83	384,900,000

Chapter 4

Companies and tax

Taxation of companies – especially large companies – is very important in developing countries. There are relatively few of them, making it relatively easy from an administrative perspective to raise significant revenue, and corporate income tax is likely to be progressive.

However, companies frequently find ways to pay less tax than the headline rates, and governments often either support this or are unwilling to tackle it. They negotiate tax exemptions in exchange for investment; small companies remain informal and/or engage in fraudulent practices to hide profit; larger companies use complex structures and tax havens to avoid large amounts of tax.

How much money is involved?

Estimation in this area is fraught with difficulty, especially on tax avoidance and evasion, as these practices are often kept secret by those involved. Estimates must be interpreted cautiously.

Nevertheless, the estimates that do exist are large. They generally refer to illicit capital flight, which includes financial flows concealed for the purposes of tax evasion, but also for other reasons including money-laundering and public corruption; rather than foregone tax revenues themselves. For example, during 2000-08, Tanzania is estimated to have lost US$2.5 billion to illicit capital flight; an annual average of US$278 million.[50]

Evidence from a 2005 survey of 1,100 Cambodian enterprises reveals a significant 'tax gap' between expected and actual revenue collection. Instead of the official tax rate they should have paid at 4.4% of turnover, the effective tax rate actually collected from or paid by the enterprises accounted for only 1.1%.[51] Accordingly, revenue loss was estimated at about US$ 400 million in 2005 – four times the collected amount.

Smaller companies and tax avoidance

The general culture

Of our case study countries, the general culture of taxation is most clearly set out in the Nigeria report. "The Nigerian tax structure is seen by most citizens as a legal imposition, and often an undesirable imposition which bears no relation to the responsibilities of citizenship, nor to the service provided by the state. Many Nigerian citizens provide electricity, water, education and other social amenities for themselves... It is therefore necessary to restore confidence to the citizens, by providing effective services and creating general awareness about taxation in the country. This will reduce the incidence of evasion, avoidance and non-compliance with relevant tax laws."

One respondent to a survey carried out in Nigeria – a supermarket operator – had this to say:

"The tax administration system in Nigeria is full of loopholes to the extent that even the people in charge of tax administration cannot be trusted. Sometimes they tell you that if you give them some gift, they will help you reduce the amount of tax you have to pay. I normally don't pay tax to anyone but we get into their net when we need a tax clearance certificate."

An interview with a Nigerian state government Budget Director revealed that poor monitoring facilitates tax avoidance and evasion, claiming that some banks operating in his state had defaulted for three years because the internal revenue office assumed voluntary compliance.

How smaller companies avoid tax

Tanzania is the spotlighted case study in this area; tax evasion appears to be a greater problem there than in other similar countries. For example, managers in Tanzania estimate that a typical firm reported

69% of its sales for tax purposes, compared to 77% in Uganda and 86% in Kenya. Reporting rates are highest amongst the biggest small enterprises. Micro-enterprises reported only 28% of sales.[52]

Techniques used to under-report sales and overstate losses include the practice of using at least two account books. One is used for entries of actual business performance – mainly for loan applications to banks. The other book is for tax purposes, in which sales are under-reported and losses overstated. Other techniques include unreported cross-border trade (which also involves smuggling). For example, according to the East African Business Council there was in 2008 about US$600 million worth of unrecorded or undervalued cross-border trade between Tanzania and Kenya. Data from the Kenyan side of the border indicates that US$706 million worth of exports entered Tanzania in 2007. However, corresponding figures on the Tanzania side showed that imports from Kenya within the same period accounted to just US$103 million.[53]

A 2007 analysis by PricewaterhouseCoopers noted that there seemed to be an endemic tax avoidance culture in Tanzania and that some Tanzania Revenue Authority officials seemed to encourage or fall victim to that culture.[54] This has led to public mistrust.

Under-reporting sales is also a common tax avoidance strategy in Cambodia. An Investment Climate Survey found that in 2007 only 65% of sales (by firms of all sizes) were reported for tax purposes,[55] up from 48% in 2003. Larger firms, firms with foreign ownership and export-oriented firms reported higher percentages of sales, and reporting had improved between 2003 and 2007 in all categories.

In Cambodia, the law provides a major tax loophole. Cambodia's tax law does not require some taxpayers to produce or keep financial reports. Thus, taxpayers can easily manipulate the size of their business turnovers, and it is not easy for tax officials to detect.

	Informal expenses as % annual sales			% of total sales reported for tax purposes		
Enterprise characteristics	2003	2007	Change	2003	2007	Change
Size of enterprises						
Small enterpirses	4.3	4.2	⬇ -0.10	42.8	53.1	⬆ 10.3
Medium enterprises	6.3	4.2	⬇ -2.09	58.0	67.2	⬆ 9.2
Large enterprises	6.8	3.9	⬇ -2.85	60.6	73.8	⬆ 13.2
Average	5.0	4.1	⬇ -0.87	48.0	64.8	⬆ 16.8
Ownership						
No foreign share	4.8	4.3	⬇ -0.56	45.2	60.6	⬆ 15.3
With foreign share	6.9	3.9	⬇ -2.99	61.1	71.2	⬆ 10.1
Average	5.2	4.1	⬇ -1.07	48.0	64.8	⬆ 16.8
Market destination						
Domestic only	5.0	3.8	⬇ -1.11	46.2	63.3	⬆ 17.0
Export oriented	6.6	5.0	⬇ -1.65	61.1	69.1	⬆ 8.0
Average	5.2	4.1	⬇ -1.10	48.0	64.7	⬆ 16.7

Source: Cambodia Investment Climate Survey (ICS) 2003 and 2007

Large companies and tax avoidence

Large and multinational companies may engage in any of the practices discussed above. However there are also further tax avoidance options open to multinationals, whose international structure allows them to shift profits around the world, including via tax havens, to manipulate pre-tax profit levels and tax due in different countries. This is known as transfer mispricing. Multinationals are also the companies most likely to benefit from tax exemptions given to attract investment.

Regulation of transfer pricing is important to prevent tax avoidance and evasion, but in many countries the regulation that exists is too basic to be effective against the well-resourced financial and legal departments of multinational companies. For example, the Tanzania Revenue Authority's Income Tax Act 2004 recognised the problem of transfer mispricing and introduced transfer pricing rules according to the arms-length principle (that prices charged between related companies should be set at market rate). It also provides powers to adjust amounts found to fail this test. However, the rules are underused, and there is little issued guidance on their use, although guidelines are currently being drafted.[56/57]

Caroline Muchanga showing her receipt for the market tax she has to pay, Nakambala Market, Mazabuka. Zambia
PHOTO: Jason Larkin/Panos Pictures/ActionAid

Large businesses can often avoid taxes when small businesses cannot

Caroline Muchanga, a mother of three, owns a market stall in Mazabuka, Zambia. "The tax we usually pay is too high considering that the profit that we realize is very little," she says Caroline works seven days a week for almost fifteen hours a day. "Our profits are never enough," she said, as she pays a daily levy of K 30,000, and must pay rent for the stall and home, as well as buy food. She sells Whitespoon sugar produced just a few kilometres from her stall by Zambia Sugar Plc., owned by the UK multinational food company Associated British Foods (ABF). An investigation by ActionAid in 2012-13 found that since 2007, when ABF acquired Zambia Sugar, tax haven transactions structured via Ireland and the Netherlands have enabled Zambia Sugar to (lawfully) avoid some $17.7m of taxes – avoiding enough tax every year to pay for the schooling of 48,000 Zambian school children.

The Zambian government made promises of free healthcare and education, but are losing out on millions though tax loopholes and special tax breaks. "We go to government hospitals you find there is no medicine," said Caroline. She is unable to send her chidren to better schools, or provide them with healthy meals. The price of sugar has also increased affecting her small business.

It is only through government policy and regulation that this deficit can be addressed. "We feel so bad because we are suffering a lot. We feel so bad because The Zambia Sugar Company does not pay tax."

Cambodia appears to be in a similar situation to Tanzania. Its general tax law gives authority to oversee and determine related party transactions, and re-determine prices if they are not at arm's length. However, Cambodia does not yet have specific, complex transfer pricing legislation. This may be partly related to skills available in the country. Six out of seven of the certified public accountants trained so far through the government's scholarship scheme left for work outside Cambodia.

Tax incentives

Tax incentives are tax exemptions and breaks provided by government to companies and investors, often to attract investment into the country. They are not effective for this purpose. A number of studies have shown that tax incentives are only a minor factor in corporate investment decisions, other factors such as available skills, infrastructure and political stability being more important.[58] And tax incentives lose countries substantial amounts of revenue.

Corporate tax incentives lose Kenya an estimated 1-2% of GDP a year.[59] Investors enjoy one-off capital investment deductions, and exemptions given on withholding tax. A significant driver of the revenue loss are the Economic Processing Zones (EPZs) in which investors are granted a range of incentives, including a 10-year corporate income tax holiday and a VAT zero-rating on materials. Just 14% of companies operating in the EPZs are fully owned by Kenyans, indicating that foreign, not domestic, investors are the main ultimate beneficiaries of these incentives.[60]

Type of investors	Types of incentives
All holders of Tanzania Investment Centre Certificate of Incentives	Import duty exemption on project capital goods in lead sectors including agriculture, mining and infrastructure; 100% capital allowance on industrial plant, buildings and machinery and on agricultural expenditure; zero VAT on inputs for mining, agriculture, tourism and goods manufactured for export; carry over losses for five years against future profits.
Investors in the Export Processing Zones (EPZs)	Exemptions for: the first 10 years from corporate tax, withholding tax on rent, dividends and interest; all taxes and levies imposed by Local Government Authorities (LGAs); import duty exemptions on raw materials and capital goods imported for manufacturing goods in the EPZs.
Investors with 'Strategic Investor Status' (ie companies investing more than US$20 million)	They can request specific incentives and have an individual fiscal agreement with the government. Thus mining companies have individual mining agreements with the government that offer individualised fiscal incentives and usually involve tax stabilisation clauses.
Mining companies	Zero import duty on fuel and on imports of mining-related equipment during prospecting and up to the end of the first year of production; exemption from capital gains tax; exemption from VAT on imports and local supplies of goods and services to mining companies and their subcontractors; 100% capital allowance on all capital equipment (such as machinery or property).
Agricultural investors	Zero-rated duty on capital goods and all farm inputs; reduced import tariff on project capital items to zero; deferment of VAT payment on project capital goods; import duty drawback on raw materials for inputs for export; zero-rated VAT on agricultural exports and for domestically produced agricultural inputs.

Source: Tanzania Report

Corporate tax exemptions also appear to be a major issue in Tanzania, with revenue losses estimated at around 3% of GDP per year.[61] Many and various types of tax incentives are offered in Tanzania; the table below gives an idea of the wide range.

Incentives are also a major issue in Cambodia; loss of tax expenditure from incentives is substantial. A recent estimate is that tax incentives offered to companies result in revenue loss equivalent to about 6-7% of the GDP per annum,[62] 4% of which was attributed to exemptions on customs duties while the other 2-3% were losses derived from other incentives such as exemption on corporate income taxes for 'qualified investment projects' (QIPs). The garment industry benefits most from the tax incentives, followed by hotels and tourism.

QIPs are entitled to the following incentives:

0% of profit tax for the following periods:

- Trigger period: ends before the first year of making profit or after three years of earning revenue, whichever is sooner.
- Automatic period: provides an exemption fom profit tax over three succeeding years following the trigger period.
- Priority period: offers exemption from profit tax for the maximum of three succeeding years following automatic period.

100% exemption from import duties on:

- Domestic QIPs: production equipment, and product input construction materials.
- Export QIPs: production equipment, construction materials, raw materials, intermediate goods, and production input accessories.
- Supporting Industry QIPs: production equipment, construction materials, raw materials, intermediate goods, and production input accessories.

100% exemption from export tax.

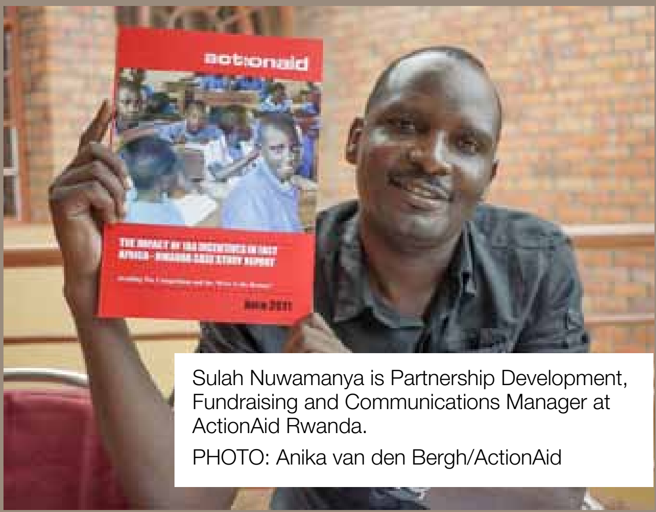
Until 2010 there was a preferential CIT rate (but this is no longer the case).

In Cambodia there is said to be a tax avoidance route related to tax exemptions. This is to get the business closed down at the end of the tax incentive period and re-registered under a new name to re-benefit from the tax incentive under the new scheme.

Nepal's response on the issues of large corporate tax avoidance, however, was markedly different from that of the other countries. According to the Nepal report, Nepal has, "hardly a significant role in attracting foreign investment to this conflict ridden country... tax havens are hardly a problem in Nepal."

Mining and oil revenue

Extractive industries comprise a major part of foreign direct investment (FDI) in many African and other developing countries. Revenue from these industries has its own unique characteristics. First, some of the revenue is not tax at all, but payment for the products and royalty payments (payment the extracting company makes to the country for the one-off benefit of extracting its irreplaceable natural resources). Second, when natural resources are found and investment made in their exploitation, the revenue benefits to the country can be sudden and very large. The absence of a period of slow, sustained building of a tax system means the opportunity to build a social contract, with the accompanying governance benefits, is lost. Furthermore, the windfall can remove any incentive to conduct this painstaking, politically contentious work; this is part of the syndrome of effects known as the 'resource curse'. Third, commodities and especially oil are vulnerable to extreme price volatility, making revenues very unpredictable. Finally, reliance on resource revenue is unsustainable in the long run, as reserves eventually become exhausted.



Sulah Nuwamanya is Partnership Development, Fundraising and Communications Manager at ActionAid Rwanda.

PHOTO: Anika van den Bergh/ActionAid

Impact of tax incentives in Rwanda

Sulah Nuwamanya is Partnership Development, Fundraising and Communications Manager from ActionAid Rwanda.

In 2011, ActionAid Rwanda commissioned a report on the impact of tax incentives in Rwanda . The report showed that Rwanda was losing US $200 million every year, which was a quarter of its potential tax revenue.[63]

After lobbying, the government accepted the recommendations and more than halved tax incentives – from RWF 10 billion to RWF 4 billion.[64/65]

The extra RWF 6 billion (US$9 million) was allocated in 2012-13 budget for pro-poor projects including electricity in rural areas, credit & saving, national health insurance and the one cow per family policy, which ActionAid is involved in implementing. Sulah is now studying the 2013-14 budget to make recommendations on where this money should go.

In Tanzania mining comprises a significant component of FDI. Transparency is needed in this area, and the extent of tax paid by the mining companies is unclear. In a breakdown of mining revenue provided by the Tanzania Minerals Audit Agency, 65% of the tax that is 'paid by' Tanzania's mining sector is personal income tax borne by employees of the companies. As a comparison, the corporate income tax that comprises the companies' own contribution is just 6% of mining-associated tax revenue.[66] This very common way of reporting corporate taxation is scandalously misleading in itself.

The issues accompanying extractives revenue are taken to an extreme in Nigeria, as we have already seen. Nigerian oil revenues (including taxes, sales revenue and royalties) comprise 70% of total revenue. At independence oil revenue was only 9% of the total, but this changed drastically with the oil boom in the 70s. The oil shocks (massive oil price increases) of 1973, 1979 and 1994 brought windfall gains to Nigeria.

The Nigerian government has signed up to the Extractive Industries Transparency Initiative as a safeguard against corruption, to build a transparent accounting system for oil, gas and other extractive industries in the country. The work of the Nigeria Extractive Industries Initiative (NEITI) has opened up the oil and gas sector, to some extent, through an independent audit. This is a first step towards greater transparency, but does not require publication of the information needed to detect tax avoidance or evasion.

Conclusion

Large amounts of revenue appear to be lost by developing countries from companies, via tax exemptions, evasion and avoidance. Yet corporate income tax tends to be progressive. Attention to this area could be productive, in terms both of increasing revenue and reducing inequality.

Chapter 5

Improving tax administration

Developing tax administration – the effectiveness and efficiency of the tax system – can be challenging in developing countries: bureaucratic inertia, political opposition and sheer lack of technical capacity can combine to make progress slow. But many of the case study countries have made major progress over the last decade or so. This progress includes establishing well-resourced revenue authorities at arm's length from finance ministries, and legal changes attempting to improve revenue levels from various sources.

For example, the tax policy changes in Tanzania have included: establishing the Tanzania Revenue Authority (TRA) in 1996; introducing VAT in 1998 to replace sales tax; a new Income Tax Act in 2004; and revisions to customs policies and administration driven by the East African Community (EAC) Customs Management Act of 2004.

These changes are said by Tanzanian key informants to have contributed to increasing revenues. TRA as a semi-autonomous government agency is perceived to have well educated, skilled and motivated staff (which presumably contrasts favourably with perceptions of the previous revenue department). The tax administration systems in Tanzania (national and local) have some capacity to implement changes, but according to ActionAid's Tanzania report, "there are also challenges, including inadequate quantity and quality of human resources with needed skills, knowledge and experience."

Kenyan reforms included introducing VAT in 1989, and from 2003, personal income tax payers were required to file a tax return (this is now being eliminated for those whose income is all paid as wages). Also, the Kenyan Revenue Authority (KRA) has become a semi-autonomous agency. However, some concerns over the real independence of the authority remain, as the Board Chair is appointed by the President of Kenya. Also, the Ministry of Finance retains authority to grant tax exemptions, which can undermine attainment of KRA's revenue targets.[67]

The Nigerian tax system is a complex combination of local, state and federal taxes. This can result in significant multiple taxation of individuals and companies, despite the availability of a list of tax jurisdictions. Lagos accounting staff said, "We pay all sorts of taxes by different governments. Today it is one tax, tomorrow another and nobody explains to you when you ask about the reason for the multiplicity. To worsen the situation you don't even know who to complain to." A small scale operator said, "I don't understand the tax policy and my obligations...I had gone to many places before I was told that I have to pay to the federal government and not the state. The Federal Inland Revenue Service needs to sensitise the people".

The culture of resistance to paying tax by Nigerians is also said to be attributable to the fact that, "the almost exclusive dependence on oil wealth has also promoted profligate spending at all the tiers of government and serves as a disincentive to potential taxpayers".[68] Moreover, according to ActionAid's Nigeria report the administration of tax collection is weak because funding, skills and infrastructure are lacking.

A further Nigerian issue relates to the interaction between federal and state level tax collection. VAT, withholding tax and income tax are collected by federal level agencies but are not necessarily sent on to central government. As at December 2006, over N61 billion (US$488 million) was estimated to be owed by some of the federal government tax collection agencies to the FIRS.[69] Over N3 billion (US$24 million) in un-remitted tax revenue was recovered into government coffers from 11 federal agencies through a review of public sector agencies for tax compliance between 2000 and 2005.[70] If the 2006 estimate is correct, this hardly scratched the surface of the problem.

Such problems are being tackled in Nigeria. In 2002, a study was inaugurated by the federal government to examine tax policy and make recommendations for improvement. Also FIRS was to be granted autonomy and additional powers, and there was to be a shift from indirect to direct taxation. To achieve this, a Personal Income Tax Act was recommended; it was finally passed in May 2011, making it the first major amendment to income tax law in Nigeria since 1979.

Our Nepal report included a survey of key stakeholders. Similarly to the other countries, they said that the current tax system suffers from weak enforcement and implementation of tax laws, ineffective taxpayer education, a lack of technical skills and a lack of political intervention. The main challenges of tax administration were said to be corruption, lack of accounting and auditing skills, weak public sector infrastructure, low public sector salaries, and lack of job definition and responsibility. Also, the tax regime and tax administration system both tend to stick to traditional practices rather than innovate; staff who attempt innovation are not rewarded by the hierarchy.

Conclusions

Improving tax administration – the effectiveness and efficiency of the tax system – could increase revenue collection in most developing countries. However it is not a simple process, and in particular sustained political support is crucial.

Just as important, however, is to develop a culture of taxation. Tax will only be paid if citizens trust that it will be used for the public good.

Chapter 6

Campaigning on tax justice: defining national priorities

Better tax systems are crucial to development. They could provide desperately needed finance for public services, reduce inequality, make governments more accountable and afford developing countries greater self reliance. They are currently starting to receive the political attention that they deserve.

The good news is that tax systems are improving. Developing countries, on the whole, are taxing more than ten years ago, they are depending less on aid (so they have more policy autonomy), and more of their tax is direct tax, which is often more progressive than indirect tax.

The less good news is that progress is slow. There are many ways that tax systems could be improved, from both revenue-raising and inequality-tackling perspectives. Some of those highlighted in ActionAid's national reports include proposals that governments:

1. Publish easy-to-understand, timely and accurate budgets, as a step towards taxpayer education and public trust.
2. Ensure spending on essential services is at internationally recommended levels.
3. Carry out distribution analyses of tax policy changes, to test their progressiveness from income and gender perspectives.
4. Provide VAT zero rating or exemption on a range of essential goods such as food and fuel, to enhance the progressiveness of this tax from both gender and income perspectives.
5. Ensure companies pay a fair amount of corporate income tax, by clamping down on tax avoidance and evasion, and reviewing policy on corporate tax exemptions.
6. Aim to increase revenue from personal income tax by making it more progressive and improving collection and monitoring systems.
7. Work on bringing the informal sector into the tax system, but with great care to ensure that the poorest are protected and that this is a progressive, not regressive, measure.
8. Give attention to capital gains and property taxes.
9. Plan to reduce reliance on resource revenue, and ensure transparency around existing resource revenue.
10. Systematically improve tax registration and collection, and co-ordination between relevant ministries and agencies.

However, the fiscal situations of ActionAid's five case study countries are very different, so therefore the priority issues for research and advocacy in the countries are also different. One size does not fit all, and each country needs to focus differently.

ActionAid held a seminar attended by stakeholders from government, academia and civil society in each case study country in late 2012, to debate what the most appropriate national tax justice advocacy priorities might be. The outcomes of the discussion, combined with the conclusions from the national reports, are summarised here (with more detailed workshop notes in the Appendix).

National tax justice priorities

Kenya

- Raise more revenue, without compromising justice, through developing a range of new and existing taxes and broadening the tax base.
- Increase progressivity of personal income tax, VAT and excise tax.
- Mainstream gender needs into the tax system.

Tanzania

- Raise more revenue by broadening the tax base, in particular by focusing on corporate

> "When government, often run by incompetent political swindlers, is itself incapable of shouldering the august responsibility posed by the nation, the people, the living sovereigns of the soil, must come forward to hammer these sluggish heads… Thus civil society as speaker of the voiceless majority of common people, must come forward and warn the people's so called representatives to heed to people's voices for just tax system and more properly tax justice."
> ActionAid Nepal report

tax. Exemptions and avoidance, but ensure this is done with equity in particular with care in how tax is introduced in the informal sector.

- Increase transparency, particularly by integrating a tax dimension into budget tracking work.
- Make taxation more progressive.

Nigeria

- Improve the quality of public spending, in particular by improving accountability and transparency in government processes.
- Tax better in the oil sector.

Cambodia

- Reduce tax incentives.
- Increase taxation of the informal sector.

Nepal

- Develop a strategic revenue/expenditure plan to fight poverty and inequality, ensuring Gini co-efficient falls at least to 1990 levels.
- Develop a tax performance plan to improve tax collection and plug loopholes.
- Improve transparency and accountability in tax matters.

As might be expected, the countries all focused on increasing revenue, increasing progressiveness and on transparency, but with different emphases.

- Cambodia has conventional revenue-raising proposals: reducing tax incentives and taxing the informal sector.
- Nepal and Tanzania also placed a high priority on increasing revenue.
- For Kenya and Nigeria (countries with higher revenue/GDP ratios) the priority was to increase progressiveness. In Kenya's case this was through a range of interventions but with a particular focus on the current political opportunity of campaigning to maintain VAT exemptions. For Nigeria the focus was on the big revenue source, the oil industry.
- For Nepal, the least advanced country in tax terms, the priorities are transparency and accountability, and concurrent taxpayer education. This was also a priority for Nigeria, the country with the highest resource revenues, and Tanzania.

These results confirm one of the main conclusions of this report - that one size does not fit all. Each of the five countries will advocate for more progressive and transparent taxes, progressively and transparently spent – but the countries' individual circumstances make the priority campaigns different in each case.

Nevertheless, these campaigns for tax justice will happen – and when they succeed, poor people will have better funded public services, more equal societies, more accountable governments and greater national policy autonomy and independence from donors. Tax justice – in the domestic and international arenas – is an issue whose time has come.

Glossary

Aid dependency – relying on aid revenue for a high proportion of public expenditure.

Deduction – a payment permitted to be deducted from earnings before tax contribution is calculated.

Exemption – a specific provision not to tax something that otherwise would be. For example, some items may be exempt from VAT, and some companies may be permitted exemptions in taxes to encourage them to invest.

Incidence – the incidence of a tax falls on the group that ultimately bears the economic burden of paying it.

Informal sector – the part of the economy that is not registered with official bodies.

Marginal tax rate – the tax rate on the last unit of currency on which tax is paid; therefore is the rate at which tax is paid on increased income when income rises.

Recurrent spending – spending that does not result in the creation or acquisition of new fixed assets.

Tax effort – a measure of how well a country is doing on tax collection, in relation to what could be expected given its economic potential.

Total revenue – tax revenue plus revenue from other sources, such as sale by state-owned enterprises, and royalties.

Transfer pricing – pricing of goods and services traded within subsidiaries of the same multinational company.

Transfer mispricing – over or under pricing of goods and services traded within the same multinational company (compared with the market price) in order to transfer profits between different jurisdictions, often in order to avoid or evade tax.

Withholding tax – when a tax is taken from an individual or company's income before the income reaches them. Many countries require companies that are making payments to other foreign companies to pay a withholding tax on them.

Zero rating – applied to VAT; a VAT rate of zero per cent is applied to zero rated goods.

Appendix

This appendix sets out in more detail than in the report text the conclusions from the national reports and stakeholder workshops on advocacy priorities in each case study country.

The seminars, and their reporting, took a range of different forms and it was done at differing levels of detail; this is reflected in the varying length of the reports given here.

Notes from Kenya

1 Raise more revenue, without compromising justice.

Ways to do this:

- Reintroduction of capital gains taxation: a highly progressive tax.
- Stronger taxation of property: another likely progressive tax. The property market in Kenya is booming but property taxes make up a miniscule part of revenue, and those that exist are not enforced. Property tax would also be collected at regional level making devolved governments more self-reliant.
- Reduction and removal of tax incentives and exemptions for investors, in particular in export processing zones: this would again likely be progressive, and could include advocating for an annual tax expenditure review.
- New top marginal rate in the PIT: a new top marginal rate of 35% (for example) would increase progressiveness.
- Measures to bring the informal sector into the tax system: this would need care to ensure it targeted high and middle income earners, not poor people. For the latter, there should be a voluntary approach to formalisation, using simplification and incentives.
- Increased coordination between the Ministry of Finance and KRA when setting and implementing revenue targets: This could be through removal of the Ministerial authority, often used arbitrarily, to grant tax incentives and exemptions.

2 Increase progressivity of PIT, VAT and excise tax.

Ways to do this:

PIT

- Review of the tax brackets to adjust for inflation: and a legal requirement for their annual review.
- Review of the tax brackets to make the PIT more progressive: by raising the threshold for paying PIT, moving the top rates upwards, and a new higher top bracket – all over and above inflation adjustments.

VAT

- Amendments to the proposed VAT Bill: to ensure pro poor zero ratings and exemptions are retained.
- Removal of unnecessary exemptions and zero-ratings: for example purchases made by the President’s office, and certain sports; some of these are proposed in the current Bill.

Excise taxes

- Increase in tobacco taxation to discourage smoking, but preceded by distributional analysis to ensure this measure would be progressive.

3 Mainstream gender needs into the tax system.

Ways to do this:

- Increase awareness of the link between gender equality and taxation.
- Gender review of the proposed changes in the VAT Bill: we need to review critically any proposals which will make VAT more gender-regressive by removing exemptions and zero ratings.

The top priority was to campaign on the proposed VAT Bill.

Notes from Tanzania

Tanzania's was the only case study report that referred to its government's positive plans on tax. Tanzania's 5-year Development Plan 2011-16 aims to increase the tax/GDP ratio to 19% by 2015. This will be done by improving tax collection and its management, reducing tax exemptions, bringing more of the informal sector into tax, and improving management of tax collection. Tanzania also wants to increase revenues through a range of innovations including financial transaction taxes, carbon taxes, controlling illicit flows and a super profit tax on minerals.

Tanzania's civil society priorities were as follows.

1 Broaden the tax base:

- Reduce corporate tax exemptions and avoidance.
- Ensure government sees tax as a developmental tool, not just a revenue-raising activity – an example given was that charges on some small scale traders are huge, and can stifle business activity.

2 Increase transparency:

- Integrate tax work with budget tracking work.

3 Increase tax progressiveness:

- Increase the minimum PIT threshold.

Notes from Nigeria

1 Improve government spending:

Citizens will only become willing to pay more tax if it is clear that spending on public services has increased and improved.

Ways to do this:

- Increase accountability and transparency in governance processes, for example in budgeting and tenders for contracts; external audit of accounts of all ministries.
- Make public spending visible, for example by earmarking.
- Place oil revenues and royalties in a development account.

2 Better taxation of the oil sector.

Ways to do this:

- Strengthen and implement laws and sanctions against tax evasion and avoidance.
- Invest in financial and accountancy skills and capacity in Nigeria.
- Reduce tax exemptions and tax holidays.

Notes from Cambodia

1 Reduce tax incentives.

Ways to do this:

- Reduce existing tax incentives gradually rather than suddenly.
- Improve the investment climate in other ways to compensate, for example improving rule of law, infrastructure, electricity provision, and labour productivity.

2 Increase taxation of the informal economy.

Ways to do this:

- Oblige SMEs to formalise, but with low tax rates, or incentivise formalisation with a very low tax rate (which can be increased later, gradually).

Notes from Nepal

1 Develop a strategic revenue/expenditure plan to fight poverty and inequality: ensuring the Gini co-efficient falls at least to 1990 levels.

2 Develop a tax performance plan to improve tax collection and plug loopholes.

3 Improve transparency and accountability in tax.

The priority is to improve transparency and accountability.

The Nepal seminar, in addition, highlighted the very low level of popular knowledge and understanding of tax.

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[3] IMF (2011), Revenue Mobilisation in Developing Countries

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[7] All our five case study countries apart from Nigeria are low income countries

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