Simplifying Taxes in East Africa

A member of the staff of the Fund's Fiscal Affairs Department considers measures to simplify taxation in East Africa and how these may provide guidance to other developing countries with the same problems and aims.

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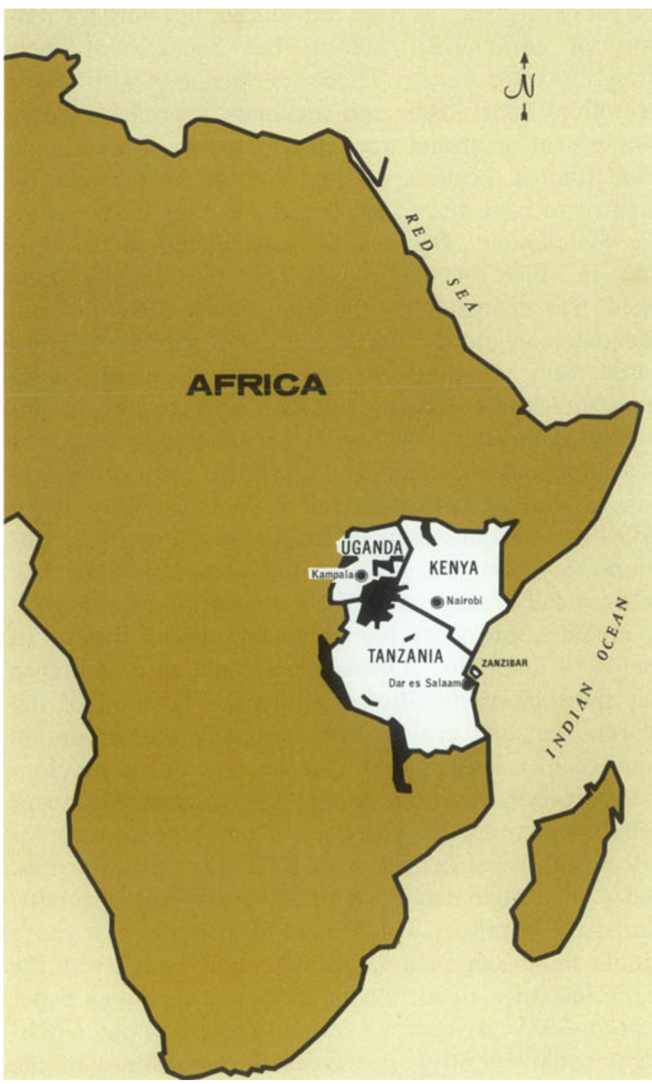

SIMPLIFIED INCOME tax has become one of the most longed-for objectives of administrators and taxpayers alike in the highly industrialized countries. High rates of tax, whatever their parentage, induce the taxpayer to search for avoidance devices—for which specialist advice from the latest of the professionals, the tax lawyer, is essential. In turn, the administration counterattacks by drafting ingeniously obscure provisions aimed at closing the loopholes. Concurrently, the tax courts are engaged in interpretation of the law in relation to specific cases, creating in some countries what may be new law in the form of binding precedent or, at the least, rulings of persuasive value. The incomprehensible verbiage mounts in volume until the administrator is drowned in a flood of his own creating.

Complication, in the tax as in other fields, is, of course, a relative condition; its cure, as well as its prevention, is a function of many variables, the rate of adaptation to conditions not being the least important. In the uncomplicated commercial environment of newly independent countries a less sophisticated tax system may be both appropriate and effective. For these countries, the difficult tax problems may be confined to a handful of expatriate corporations engaged in the mining or plantation industries whose tax affairs can be administered by one or two senior officials; the bulk of the trading community is involved in simple patterns of trade, and practices only the most obvious form of tax avoidance—understatement of profits—against which the safeguard is better administration rather than stricter law. In such conditions a standard of legal sophistication appropriate to the few troublesome cases would

not only be irrelevant but excessively complicated—relative to the bulk of the community and to the caliber of the tax officials. While tax legislation of the complexity found in the western industrial world is out of place in such conditions, the adaptation to changing environment is still vitally important.

Such prompt adaptation to rapidly changing political and economic situations is well illustrated by the East African experience over the past 20 years, and since one of the functions of the Fund's Fiscal Affairs Department is to conclude from experience in one situation what may be the practical possibilities in comparable situations, a description of some of the East African developments may have illustrative value.

East African Background

The income tax introduced in Kenya in 1936, and extended to Uganda and Tanganyika in 1940, was based on the rudimentary U.K. "Model Ordinance for Colonies Not Possessing Responsible Government" of 1922; the three laws were administered by a joint income tax department. Following the creation in 1948 of the East Africa High Commission (the forerunner of the present East African Community), with legislative powers over all three countries, a consolidated law was passed in 1952, incorporating certain refinements which experience had shown to be necessary. At that time, a Commission of Enquiry was promised to review the whole field of income taxation and this was set up and completed its review in 1956/57; a rewritten law incorporating modern concepts and many of the recommendations of the Commission was passed in 1958; within the next four years all three countries obtained independence, political control passing from the expatriate to the indigenous communities; however, a joint tax administration and joint management legislation operate to this day.

Adaptation to environment took place in two major phases. The first covered the period of increasing commercial sophistication and industrialization induced by wartime economic development and its aftermath of substantial immigration and capital inflow from Europe; the second period of adaptation witnessed the anticipated and actual effects of independence, principally in the transfer of the tax administration from expatriate to local control, but also in the change in the nature and content of the taxpayer population.

The First Phase

During the first phase, which lasted until 1958, adaptation showed itself principally in a growing legal sophistication, much of which was aimed at countering avoidance of tax. For example, prior to 1952, the law had included a general antiavoidance provision related to transactions which were "artificial or fictitious," and authorized the administration to disregard their tax effects. The courts having found this phrase inoperable in practice, the provision was replaced in 1952 by one related to transactions, "the main purpose or one of the main purposes of which" was the reduction or avoidance of liability to tax. The remedy provided was the setting aside of the transactions and treatment of the case as if these had never occurred. Notwithstanding some startling effects of this in practice, and the subjective element of motive which was involved, this provision has stood the test of time, largely through its judicious use by the administration and because, where it was applied, the facts spoke for themselves as to motive.

The second of the avoidance areas was the nondistribution of profits in the form of dividends by "one-man" companies (close corporations), which form the vast majority of all East African companies. Prior to 1943, the law included a brief enabling section providing for such profits to be treated as distributed if they could have been paid as dividends without detriment to the operation of the corporation. In 1943, the provisions of the Indian legislation were introduced, not only for reasons of commercial affinity but because of their straightforward nature. These specified that with minor exceptions (past losses and smallness of profits), unless 60 per cent of profits were distributed as dividends the undistributed portion of the 60 per cent could be deemed to have been distributed and thus be taxed on the shareholder. This section was related to corporations in which the public were not "substantially interested" (as defined). By the use of clear definition and adequate safeguards, the law became specific as compared with its previous generality; inevitably, with specificity came length, breadth, and depth—or increased complexity. Although administrative resources had improved substantially during the 1950's, the taxpaying community complained at the inflexibility of the distribution requirement in relation to the need for encouraging corporate savings, and accordingly the law was critically reviewed by the Commission of 1956/57. A modification of its recommendation was enacted in the 1958 law. This substituted a penal rate of tax on the shortfall of distributed profits for taxation of the shareholder, and provided the company with an option between (1) deduction of 100 per cent of the development expenditure in the year (90 per cent of which was withdrawn over later years at 10 per cent a year) together with a flat deduction of 27½ per cent of profits, and (2) a single deduction of 32½ per cent of profits. Broadly, a company which spent 60 per cent of a year's profits on development would ultimately be left with the equivalent of a deduction of 27½ per cent plus 6 per cent, or 33½ per cent, i.e., would require to pay a dividend equal to 66½ per cent of the profits; in the meantime, it would have a diminishing "tax loan" over

the period in which 90 per cent of the development deduction was being withdrawn; under the second option it would have to pay a 67½ per cent dividend immediately. On the same basis, a company which spent 40 per cent on development would ultimately be left with a deduction of 31½ per cent, though under the second option its deduction would be 32½ per cent. Subject to the value of the tax loan, therefore, the point of equal treatment occurred where 50 per cent of profits were plowed back for development. The definitions and other control provisions were increased in number and complexity in a further attempt to ensure avoidance-proof legislation.

The third avoidance aspect was a side effect of the postwar capital accumulation in the hands of individuals and of the high individual tax rates (the maximum marginal rate was 75 per cent). It involved the creation of trusts of capital, the income from which would be paid, typically, to children, grandchildren, or charities. The East African law having made no provision for alienation of income per se, it was necessary for the grantors of trusts to settle capital assets in the names of trustees for specified beneficiaries. Experience showed that the trustees normally consisted of the settlor and his wife, that the trust assets were frequently shares in the family company, and that the income was not distributed but was accumulated in the trustees' account maintained in the books of the company. The end effect was to leave the grantor with all the benefits of ownership of the assets and most of those of utilization of the income. The 1952 Act confined its attention to a provision against trusts in favor of the settlor's minor children; the 1958 Act extended the net to all "revocable trusts" with a wide definition of the circumstances of revocability, including control of the assets or income of the trust by any means; the income of such trusts, like those for minor children, was to be treated as that of the settlor. This too involved not only complicated drafting, but also an incursion into the law of trusts.

During this first phase the graduation in the burden of tax on individuals was also highly refined by reference to their personal circumstances. Thus, under the 1952 Act not only were there the traditional married, child, dependent relative, and life insurance reliefs common in many developed countries, but a complicated education allowance based on the amount of tuition fees and boarding fees paid, an "age" allowance, an "old age" allowance, a passage deduction in respect of the cost of travel to countries outside East Africa (relief for the cost to the expatriate of his home leave), and a sophisticated relief for contributions to pension, provident, and self-employed retirement schemes. These, together with a rate schedule in which the rate of tax increased with each additional monetary unit of income, reflected the fact that the tax applied in prac-

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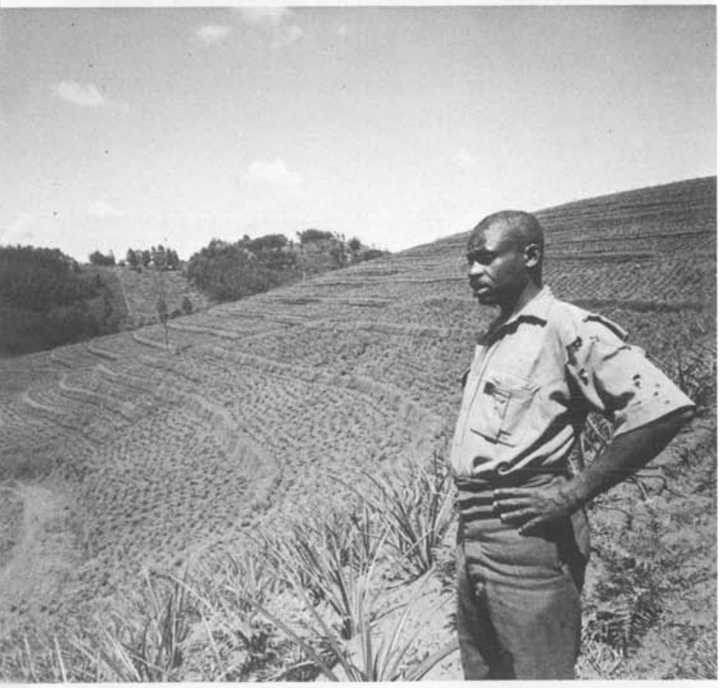


exodus from the three countries of most of the general civil service, as well as many of the businessmen and wealthy farmers; it involved the addition of a new group of income taxpayers of local origin."

tice almost entirely to the expatriate communities, European and Asian, by granting the tax treatment which these might have expected in their countries of origin.

Adaptation, in this phase, was directed to a highly developed expatriate population (supported by tax advisors of international standards) through the use of a professionally trained and experienced expatriate tax administration. The sophistication of the taxpaying community was countered by increasingly sophisticated taxes.

The Second Phase

The second, or post-1958, phase of adaptation to changing circumstances in East Africa heralded the approach of independence; the prospect of the administration being transferred to an inexperienced and newly recruited local civil service created a very different situation.

Experience in this phase illustrated the not infrequent conflict between what is desirable in tax policy and what is feasible in tax administration. There had been developed an equitable progression in the individual taxpayer's burden according to his ability as measured by a delicate and refined instrument, incorporating many modern concepts; the degree of sophistication in the taxpayer's endeavors to minimize his burden had been matched by a necessary but not excessive degree of complication in the safeguards embodied in the law; schemes for further refinement were in the air. So also, however, was the wind of change.

Change involved the replacement of fully trained and highly experienced expatriate personnel by local staff (the majority of whom had no previous commercial or professional experience) and their training by means of a "crash program"; it involved an exodus from the three countries of most of the general civil service, as well as of many businessmen and wealthy farmers; it involved the addition of a new group of income tax payers—civil servants, senior commercial employees, and new businessmen—of local origin.

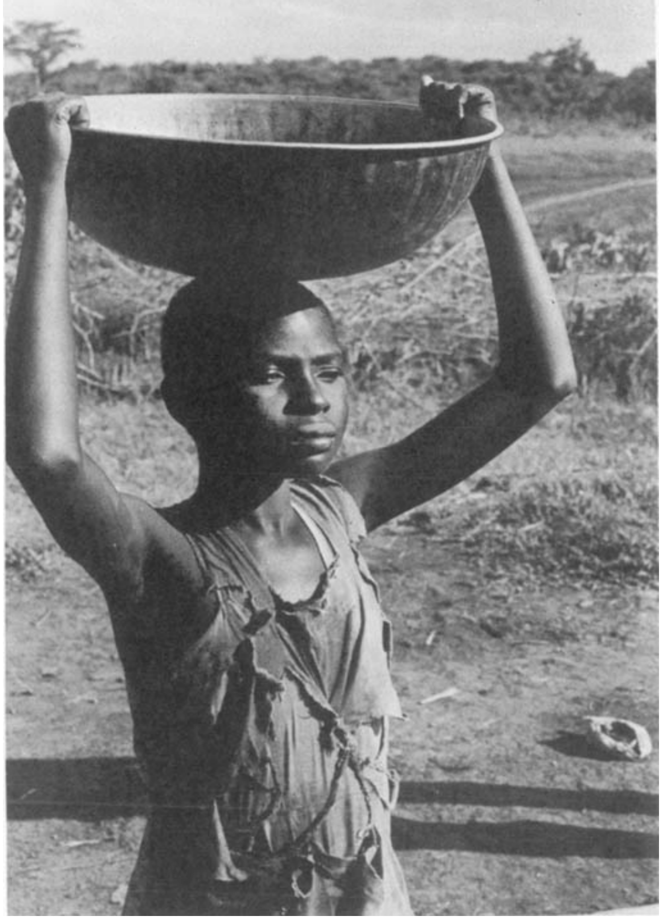
Of necessity, adaptation to the new situation took the form of simplification; this was at the inevitable cost of rougher justice—or less equity—between taxpayers; it also involved abandoning certain tenets of fiscal theory. Thus the principle of taxing resident taxpayers on their world-wide income was abandoned on the ground that, with the availability of treaty and unilateral double taxation relief, there was very little net tax revenue from overseas income and what there was did not justify the employment of scarce skilled officials which the technical difficulty of this subject required.

Then a radical reduction was made in the variety of personal reliefs. Coupled with this was an increase in the married allowance aimed at reducing the number of income tax payers, and so the administrative work load. (In all three countries incomes in lower ranges are taxed by means of a graduated personal tax—a development of the poll tax.) The education, dependent, and old age personal allowances were abolished in 1961, together with the passage deduction for travel, reflecting the egalitarian attitude to local residents and expatriates. Again with a view to eliminating unnecessary procedures, a move was also made toward eliminating credit to shareholders for company tax deducted from their dividends. For this purpose company tax was divided into two parts, only one of which was credited to the shareholders on payment of a dividend. The intention was to move by annual steps (with the object of minimizing the effect upon local stock exchange quotations) toward complete denial of credit, and this movement was completed in 1965. After that, the carefully constructed but highly complicated control over close corporations was abandoned and reliance is placed on the general antiavoidance "main purpose" section, which, by specific reference, now covers such controlled companies. Whether a safeguard directed at positive steps to avoid tax will be equally effective against the negative action of failure to declare dividends remains to be seen.

Later Developments

In 1961, with the object of assisting both taxpayer and administrator, depreciation relief was simplified by reducing to three the categories of machinery admissible for relief, and by introducing the rollover principle of adding the cost of additions and deducting the proceeds of sales in each category. This involves taxing any capital gain on such assets, a breach in the policy of not taxing such gains in East Africa. Here again, by condensing the categories into three there was some element of overallowance or underallowance in the short run, i.e., less refinement.

On the purely administrative side, implementation of the advice received from the IBRD, the 1956/57 Commission, and other sources toward setting up an employee withholding scheme was deferred until the major exodus of expatriate civil servants and other taxpayers in the postindependence period was over. However, in 1965 (operative from July 1, 1966), a withholding scheme was introduced, accompanied by a major change in rates of tax on individuals and by a change in the basis of assessment from the previous year to current year income. Previously, employees paid no tax during the first year or 18 months of employment, being assessed a year in arrear, the tax being collected by the employer under instruction from the tax department. With the introduction of "pay as you earn" it was necessary to provide for deduction of tax from the first pay day, and for liability to be based on income during the current year. The introduction of withholding also made it possible to derive an ancillary administrative benefit from the simplification of personal reliefs; the



administration could now require the employer to deduct tax according to a claim for reliefs made to him by his employee; apart from sample-checking these returns, the administration was then able to step out of the picture.

Concurrently, a flat income tax rate of 12½ per cent was introduced and this is the effective rate for taxable incomes (excess of total income over personal allowances) of up to £1,000, the previous minimum rate having been 10 per cent on taxable incomes of up to £400 with a further £400 at 15 per cent, a third slice at 20 per cent, and thereafter to 75 per cent. To this flat rate of income tax a graduated super tax was now added for taxable incomes over £1,000. The practical effect of having such a large low-income bracket is that approximately 50 per cent of employees are liable at a single rate of tax, so that fluctuations of income during the year, which give rise to complication in more refined tax systems, have no effect. In these cases, because of the single rate, the tax deducted by employers periodically over the year can be expected to equal the actual liability of the employee calculated on his total year's income, with the result that the administration is not plagued by assessment adjustments at the year end, by minor tax refunds, or by collection of small underdeductions. To achieve this objective it was also necessary to restrict the tax base, for this group of employees only, to cash earnings, by abolishing the charge on remuneration in kind—the valuation of which is always a troublesome administrative task.

Now, in standard fiscal theory a long low-income bracket at the high rate of 12½ per cent offends against equity in being a proportional tax for a large section of the community. To have maintained for them the progression provided by the previous scale of rates, however, would almost certainly have overburdened the newly formed local tax administration with just the kind of difficult adjustments that the authorities sought to avoid. This would have resulted in arrears of work, dissatisfied taxpayers, and lower revenue. Whether "equity" in terms of a more perfect graduation would have justified such an effect is hardly debatable.

Lessons from East African Experience

The East African experience illustrates the fact that if the current amounts of revenue collection are to be maintained, simplification involves a reduction in the level of equity aimed at by the legislation. It is unfortunate that so few governments appreciate that the equity embodied in the law is often purely theoretical; experience in many undertrained and undermanned tax administrations shows that ideal concepts cannot be achieved with the resources available and may largely be ignored in practice. Many developing countries (particularly those attaining independence and bearing the double burden of sophisticated colonial legislation and undertrained indigenous personnel) still place excessive stress upon the trappings of equity in the taxation of income. Thus, refined reliefs, the perfection of progression, the scope of the tax base, and the safeguards against its erosion occupy a rather artificially important position in relation to other factors. The same can be said for the complex administrative and judicial remedies available and, indeed, for the emphasis laid upon the economic or social consequences of the tax—as it is assumed to apply. It is a question whether truer equity could not be achieved (and the other consequences more realistically anticipated) by an instrument which was less zealously aimed at the abstract, which was more closely oriented to the immediate capacity of available administrative resources, and which paid greater attention to the prevention and detection of fraud—a factor which experience shows can have greater relevance to equity than tax policy itself.

The development of tax policy and administration in the East African Community also leads to the question —whither next in simplification? Elsewhere in recent years the movement has been toward further transfer of the administrative burden from the shoulders of the state to those of the public. This is already illustrated by employee withholding schemes, which cover the majority of income tax payers. The sheer physical burden on an inadequate administration of assessing income and thereafter collecting the tax is obliging governments to adopt "advance payment" and "self-assessment" schemes for the trading and professional communities;

these, though forming a minority in number, collectively account for the greater part of tax receipts. The extent to which this can be successful in reducing the administrative load is largely dependent upon the degree of commercial sophistication of the community. If most traders are incapable of a reasonably accurate calculation of their tax liability, the ultimate burden on the administration of correcting the inaccurate computations may be greater than it was before this responsibility was laid on the taxpayer. It is thus a matter of balance—of reaching an equilibrium in which the legal requirements are within the comprehension and capacity of those required to perform "do it yourself" taxation so that supervision by the tax administration is at a minimum—but at the same time ensuring that the revenue yield is not prejudiced by the degree of simplification required for comprehensibility under local conditions.

Here a warning may be needed against uncoordinated experimentation with ideas culled from dissimilar conditions elsewhere, a practice which has had harmful revenue effects in some member countries. The proper exercise of judgment in all such issues, especially in the timing of change, in the degree of simplification or adaptation required by developing conditions, and in maximizing compatibility of policy with administrative resources is of prime concern to the Fund. The nurture of sound judgment among local personnel is not only an indispensable element in Fund technical assistance endeavors in the field, but is one objective of the public finance training programs now being conducted in Washington.

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