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## TOWARDS TAX REFORM IN EAST AFRICA

### A. Fiscal policy in developing countries

(1) The purpose of this paper is to advance some proposals for the reform of the tax system in East Africa in order to ~~make~~ it a more effective instrument for the development of these countries. The main objectives of fiscal policy in any country ought to be the promotion of equity, efficiency in resource allocation, and stability and growth of the economy. But in developing countries the objective of accelerating growth ought to have priority over other objectives mentioned above.

(2) Fiscal policy can accelerate the rate of economic growth in developing countries by affecting the amount and type of investment undertaken. The share of investment in national income can be raised by increasing public and private savings through an appropriate tax structure. Thus the twin objectives of fiscal policy in East African countries ought to be to achieve a substantial surplus on the current budget and to promote the rate of private savings and investment by providing the necessary incentives.

(3) Fiscal policy has not played an important part in the development of East African countries in the past. In particular, with the exception of Uganda, East African countries have not used fiscal policy to any great extent, to generate public savings for stepping up the rate of capital accumulation. There were several reasons for this in the past, including the lack of ambitious development goals. But it is important that fiscal policy should now play its proper role in promoting economic growth in East Africa. In order to achieve and enhance public savings, it is essential that the tax structure should be income elastic i.e. the share of tax revenue in national income should rise over time. We shall, therefore, first see to what extent the existing tax structure in East Africa is adequate to provide increasing public savings necessary for rapid economic growth. Our discussion will relate to the Uganda tax structure, but since most of the important taxes in Uganda are common to Kenya and Tanganyika as well, it is hoped that our proposals for the reform of the tax system will have a relevance for all East African countries.

### B. The Uganda tax structure.

(4) The most characteristic feature of the Uganda fiscal system is its overwhelming dependence on taxes on foreign trade, mainly on imports and cotton and coffee exports. The contribution of taxes on foreign trade to total Central Government tax revenue has been well above 50% throughout the post-war period. It was as high as 80% in 1951-52, though the proportion has tended to decline in the post-1952 period. Heavy reliance on foreign trade makes for a considerable instability in tax revenue to the Central Government, caused especially by fluctuations in the price and proceeds of cotton and coffee exports. Export taxes have declined in importance in the period since 1952; while other taxes, especially import and excise duties, have tended to increase their relative importance.

(5) The other important feature of the Uganda tax system is the relatively small amount of tax revenue derived from the taxation of consumption of domestically produced goods and services. Services are hardly taxed in Uganda, while beer, sugar, cigarettes, tobacco and (since June, 1964) soft drinks are the only considerable revenue earners among the domestically produced goods.

(6) Lastly, income taxes (excluding Graduate Personal Tax) touch only a small segment of the working population. In 1961, only 9,600 persons in Uganda contributed to Income Tax revenue, and about 1,264 companies were assessed for company taxation. Thus a great majority of the economic units in Uganda are not taxed through income taxes.

C. Tax revenue and structure and growth of the Uganda economy.

(7) To what extent is the Uganda tax system responsive to increases in national income? The answer to this will depend on the pattern of growth of the economy. At one extreme, growth through a boom in export prices will make the tax revenue highly buoyant and enable the government to siphon off a large proportion of incremental income as public savings, as in the 1948-52 period. But this pattern of growth is beyond the control of the government policy and is dependent on the world economic conditions. The future pattern of growth in East Africa is much more likely to follow the pattern outlined in the Five Year Plan for Tanganyika. This pattern of growth implies certain structural changes in the economy which have considerable repercussions for tax revenue. These changes include a progressive decline in the relative importance of exports, especially of primary products; a gradual decline in the ratio of imports to national income; a change in the composition of imports, with the share of investment and intermediate goods rising; an increase in the relative importance of domestically produced manufactured goods. All this will be accompanied by changes in the distribution of income; in particular, the share of urban income will go up, as will the share of the corporate income.

(8) It is important that the tax system should be flexible and capable of adjustment to the expected changes in the structure of the economy. It is very likely that under the existing tax structure, tax revenue will not keep pace with the increase in national income if the Uganda economy experiences the structural changes noted above. The relative shrinkage of the export sector, in particular of cotton and coffee exports, especially if accompanied by a decline in cotton and coffee prices, will imply a significant reduction in the revenue from export taxes relative to national income. Likewise, a decline in the relative importance and change in the composition of imports is likely to lead to a fall in the ratio of import tax revenue to national income. This point may be illustrated from the current structure of import duties in East Africa. In 1962, no less than 87% of the total revenue from import duties in Uganda was derived from food, manufactured consumer goods (50%) and mineral fuels (29%); while construction material, equipment and intermediate goods accounting for 35% of total imports were responsible for only 6.8% of the import tax revenue. Textiles and various articles of clothing alone accounted for well over 30% of total import duty revenue in Uganda in 1963. A vigorous programme of import substitution will result in a sharp decline in the share of manufactured consumer goods and food in total imports and a sharp increase in the relative importance of equipment, construction material and intermediate goods. Thus the changed structure of imports may well result in an absolute decline in revenue from import duties under the existing structure of import tariffs.

(9) It is more difficult to predict the revenue effects of other aspects of change in the structure of the economy induced by rapid economic growth, owing to lack of adequate information on the changing pattern of consumption expenditure and distribution of income. An increase in the share of corporate income will bring this income within the net of company taxation

and will thus increase the revenue from company taxation relative to national income. It is however, unlikely that the proportion of personal income subject to individual income tax will increase, as the income tax stands at present. This is both because the relative importance of Asians and Europeans, who have paid most of the income tax so far, will decline in future in the Uganda economy and also because of the Government policy to ensure a more equitable distribution of income. Lastly, the revenue from excise taxes should prove fairly elastic.

The net effect of all these changes in the structure of the economy is likely to be a decline in the proportion of tax revenue to national income. The rest of this paper is concerned with various proposals designed to enhance the buoyancy of the tax system in Uganda.

#### D. Proposals for the reform of the tax structure in Uganda.

(10) The proposals outlined below would have the effect of a once-for-all increase in the share of tax revenue in national income as well as of ensuring a long-run income elasticity of the tax structure. These proposals consist in the main of broadening the bases of the existing tax sources and introducing several new taxes to close some gaps in the existing tax structure.

Export taxes have been an extremely important source of revenue in the past; they represent a very effective way of taxing the great majority of working population in Uganda; it is essential that they should be retained and even extended. It is the Government policy to diversify the export base by encouraging the export of products other than cotton and coffee. If the revenue from export taxes is not to decline relative to national income, an attempt should be made wherever possible to bring new exports within the net of the export taxes. With the broadening of the tax base, there will be an opportunity to raise considerable sums of revenue by levying low rates of export duty on a large number of exports such as animal feeding stuffs, tea, groundnuts, castor seed etc. Provided the cotton and coffee prices stay at their present level, export taxes should continue to bring in large sums of money. However, any significant decline in export prices such as occurred in the period 1954-62, could be a severe setback to the Governments' efforts to raise the share of investment in national income through public savings.

(11) With regard to import tax, the existing tariff structure will have to be changed in accordance with expected changes in the composition of imports, if there is not to be an absolute decline in import tax revenue. One of the ways this could be done is to put high duties on manufactured consumer goods which have a high income elasticity but a low price elasticity. However, the scope for raising large sums of money by this method is severely restricted. The more promising avenue is to raise the import taxes on intermediate and capital goods; although this proposal goes against the traditional practice of levying low rates of duty on producers goods, it will have to become a feature of the import duty structure if the revenue from import duties is to contribute significantly to the required increase in government revenue.

(12) Income Taxes: Here we must consider individual income tax and Graduated Personal Tax jointly for they are both levied on the income of the individual. With regard to the latter, an attempt should be made to make the tax progressive as between different income slabs. At the moment the tax structure in most of the districts and Kingdoms in Uganda is such as to make this tax largely regressive.

As for the individual income tax, the most important reform from the point of view of both equity and revenue would appear to lie in a reduction of single and marriage allowances. At the moment, a single individual must earn an income which is ten times the average per capita income in the country before he becomes liable to income tax; a married person has to have an income which is over 30 times the per capita income before he starts to pay any income tax. Judged by these standards, East African countries have some of the highest exemption limits in the world. The relatively generous allowances have the further effect of making the combined tax structure of income and graduated personal tax regressive within a certain range of income for married persons and married persons with children. A reduction of allowances would bring a larger number of persons within the income tax net; and as this tax is progressive, it will make available to the Government a rising proportion of incremental income.

Lastly, introduction of pay-as-you-earn will improve both the flexibility and stabilizing quality of the tax system in East Africa by eliminating a long time lag between the receipt of income and payment of income tax.

(13) Corporate Tax: Revenue should be fairly buoyant if there is a rapid growth of manufacturing and construction industry. The main problem here would appear to be the use of fiscal policy to arrest the trend towards capital intensive techniques of production. The existing structure of company taxation, with provisions for accelerated depreciation and investment allowances, while promoting capital formation, has also the effect of subsidizing capital intensive techniques of production. There is clearly a need for a tax structure which will relate tax benefits to output or to employment. Professor Paul G. Clark of the East African Institute of Social Research has elsewhere made a proposal to tie tax benefit to output increases. This idea seems extremely attractive and well worth pursuing in order that fiscal policy might be used to combat one of the greatest social and economic problems - that of unemployment - facing the East African countries.

(14) Perhaps the greatest scope for tax reform in East Africa lies in the field of indirect taxes on domestically produced goods and services. We saw earlier that the process of import substitution could lead to a decline in revenue from import duties. It is of the greatest importance that as the domestic production of manufactured consumer goods replaces imports from abroad, it should be subjected to a kind of indirect tax - excise or sales or purchase tax. This tax should be levied at a low rate in the earlier stages, but should be raised progressively as the industry becomes more competitive. Already there are several domestically produced manufactured goods - textiles, clothing, shoes, soaps, tyres and tubes etc. - on which some kind of indirect tax, perhaps at a low rate, should be imposed. Since most of these products are manufactured by a small number of firms, it would be administratively convenient to tax them at the manufacturers' level. Alternatively, consideration should be given to the imposition at the wholesale level of a low-rate general sales tax.

(14) It was noted earlier that services are hardly taxed in Uganda at the moment; yet in many respects they are the ideal 'commodities', for tax purposes: most of them are 'consumed' by the wealthier members of the society, have high income elasticity of demand and do not pose any great administrative problems. The list offered here is not exhaustive but is meant to be illustrative of the type of services that could profitably be brought within the net of taxation. Airport tax and hotel tax are already levied in Tanganyika, and are a common levy in many other countries. There seems no reason why Uganda should not follow suit; it is unlikely that a tax of this kind, if levied at a moderate rate, will have any effect on the number of tourists visiting Uganda. Another field which has not been adequately exploited in East Africa for tax purpose is entertainment; there would appear to be a strong case for taxing 'consumption' of such entertainment as football, hockey, cricket, tennis matches, as well as cinemas, theatres etc.

The existing income tax structure subsidizes foreign travel. East African countries must surely be unique in this respect. It is proposed here that this subsidy should be replaced by a taxation on foreign travel so as to reduce the loss of foreign exchange. A selective tax on foreign education, besides helping in the conservation of the foreign exchange resources of East Africa would result in greater utilization of local institutions of learning.

A strong case can also be made for financing the post-secondary education in East Africa on a loan basis. Higher education confers great financial and non-material benefits on the few privileged to receive it. It is only right that the recipients of this privilege should be asked to pay part of the price for it.

(15) The foregoing suggestions would have the effect of increasing the share of tax revenue in national income. In order to minimize the disincentive effects of high rates of taxation on savings and enterprise, it is desirable that the tax structure should embody provisions designed to encourage savings and investment. Under the present system, personal savings in the form of premia for life insurance policies are partially or completely exempted from income tax. It would seem preferable to move in a direction where all forms of socially desirable investment are partially or completely exempted from taxation.

#### E. Conclusion

(16) The above proposals have been advanced on the assumption that the Public Sector will play a crucial part in the economic development of Uganda and that a substantial proportion of capital formation undertaken by the Public Sector will be financed by taxation. It is, therefore, of the greatest importance that the Central Government should make the best use of the resources obtained through taxation. In particular, the temptation to dissipate these resources through increased consumption by politicians and civil servants in the form of higher emoluments should be strongly resisted. It is only then that the Central Government will be justified in demanding sacrifices from the people of Uganda.