

## Harmonisation of EAC Tax Policies and Laws: *Proposals for Taxation Regime for Fostering Small Business Development and Regional Economic Growth*

The harmonisation of tax regimes should be one of the priorities of the EAC member states in order to ensure a successful functioning of their common market. The current wide differences between the member states' tax regimes are an obstacle in the progress of the common market. As provided in Article 32 of the EAC Common Market Protocol, the harmonisation of EAC tax regimes would "facilitate the free movement of goods, services, and capital, and the promotion of investments within the Community", bringing immediate benefits to people in East Africa. It is important to understand where all the states' efforts should converge. As it will be shown in this policy brief, in order to ensure a people centred development strategy, it would be more appropriate trying to develop local small business in the region rather than focusing entirely on the promotion of foreign direct investments. It then also provides suitable approaches to design an appropriate harmonised tax regime for them.

### Introduction

The successful functioning of the EAC as a common market to create large investment areas and enlarge its market is dependent on how well it manages the equitable allocation of resources as well as create equal conditions and opportunities for competitors in the field. It calls for the members to prioritise cooperation in areas which enlarge trade and investment opportunities in the region. In the case of the EAC, which has wide differences in their tax systems that manifests in the unequal treatment of tax payers and goods and services, it necessitates the prioritisation of the harmonisation of tax regimes of the member states, as discriminatory tax systems distort the functioning of the common market and creates impediments in its progress. Therefore, there is an underlying shared responsibility for both the public and private sectors in the common market to promote fair and efficient tax systems and administrations.

According to Article 32 of the EAC Common Market Protocol, harmonisation of EAC tax regimes is expected to "facilitate the free movement of goods, services, and capital, and the promotion of investments within the Community", which would directly benefit the people in East Africa. In order to promote a people centred development strategy, there are various recommendations to formalise the informal sector, and particularly the micro, small and medium enterprise (MSMEs) in the region. This policy brief shall seek to address the importance of small businesses in the EAC

region and provide suitable approaches to design an appropriate harmonised tax regime for them.

### The Relevance of the Informal Sector in Tax Harmonisation in the EAC

The informal sector in the EAC is sometimes as large as the formal sector, and in Tanzania and Burundi, their contribution to GDP is higher than that of the formal sector. Because of their size, if they are formalised and brought under the tax net, they have a significant potential and role in addressing key development challenges like poverty, unemployment, and industrial development etc., in the region. Bringing the informal sector, particularly the MSMEs under the tax net by increasing the tax base and not the tax rates is one of the key solutions. But most of these MSMEs are difficult to locate in the informal sector, and hence do not fulfil business obligations or tax compliance, both out of ignorance and intent. Since they are mainly independent, family oriented, low skilled and informal, they are averse to any notion of government interference and taxation.

The governments, on the other hand, also consider their businesses to be unofficial, and hence the informal sector is subject to various punitive measures if their presence and operations are detected. Most of these businesses run a high risk element if detected, and thus they maintain a budget for bribery, which are sometimes as high as 20 percent in transition economies. Further, due to their informality, they have limited access to public services and are poorly protected by the national

security systems. Access to institutional finance, market credit and business development services is another problem faced by these enterprises which forces them to rely mainly on informal credit that is generally characterised by high interest rates and which are of short term nature.

Finally, their informality limits their prospects of valuable cooperation with the formal sector which could promote the benefits of financial support, technological transfer, training of personnel's and access to markets.

Therefore any tax harmonisation regime created to expand the formal sector in the EAC should target at providing incentives for the development of MSMEs and foster a climate for a culture of taxation. Bringing the informal sector under the tax net would have various benefits for these MSMEs and for the governments. Firstly, it would bring them under the purview of the formal sector, and hence open up various market opportunities (also exports), apart from vital access to formalised credit and government procurement. Secondly, from the government's perspective, formalisation of the MSMEs would open new avenues for their growth and potential to operate as bigger firms, hence paying more revenue. It would also encourage the inculcation of a culture of compliance.

There are various recommended methods of encouraging compliance of the informal sector by mainly adopting measures which address the factors that hinder their growth, increases costs of formalisation, and discourages their participation in formal societal institutions. One way to do this and legitimise the informal sector is to allow for tax holidays and tax exemptions, especially in low yield sectors like agriculture, at least for a specific period after which a low flat rate is charged before they graduate into relative higher income groups. Although, this procedure would require better tax enforcement, auditing and services from the government so that these tax holidays and exemptions provided do not create incentives for the recreation of MSMEs in the image of the exempted sector, thereby promoting non compliance.

While granting exemptions, governments also need to bear in mind the importance of administering taxes efficiently and according to the law by avoiding over taxing of larger tax payers and corporations. The over burden of taxation especially on these large corporations create an incentive for them to divide their businesses into smaller fragments to avoid taxation, which could be counterproductive for revenue generation. Therefore increases in their tax rates should be considered effectively.

There is also a need for reforms of the regulatory framework in Partner States of the EAC so that the process of formalisation is swift and affordable. In light of this, many studies recommend the creation of one-stop-shops for MSMEs to meet all their registration requirements for formalisation. Other studies conducted on the role of the political economy in

formalising taxation of small businesses point out that there is a need for the informal sector to adopt a business oriented attitude. In this regard, governments should shed their adversarial attitude towards the informal sector. Including and involving the MSMEs in decision making process in their communities could help in increasing accountability and transparency of local government authorities.

Moreover, government officials need to be sensitised of the importance of the informal sector. Governments can also boost the confidence of the informal sector by granting them access to productive resources including the recognition of title deeds and property rights, providing good business location, and assistance in improving linkages with the formal sector to those who comply.

From the aspect of labour regulations, dual or multiple regulations are required to enable those who can meet part of their social contributions to do so. Legislation recognising dual minimum wages and double safety nets would also provide an impetus to the contribution by the informal sector, as it would entail the micro-enterprises to contribute a low percentage of social security funds, and the state would cover the rest.

### Designing Different Approaches for Taxation

Economic theory suggests that in order to have a broad consensus on a good tax policy, it necessitates the creation of a simple tax structure which is applied across the entire economy and allowing for limited exceptions and derogations. But in the case of the EAC, small businesses need to be taxed differently for ensuring efficiency and equity. In this regard, it calls for specialised tax treatment to be granted to small businesses to ensure compliance and formalisation, before they can move to the standard taxation regime. Designing such a harmonised specialised regime in the EAC Partner States is a key challenge. In practice, the abovementioned special tax regimes have increased the number of small business registration, but not necessarily ensured their compliance. This is generally because the standard taxation regimes in these countries are very complex and the simplified tax regime only applies to few taxes. Table 1 provides information on taxation in the Partner States of the EAC.

For MSMEs, the standard taxation regime requirements are often expensive and sometimes exceed the skills and capacity of small businesses. Therefore, it is integral to adopt methods and procedures to rectify and apply the tax system according to their compliance capabilities. These should ideally manifest in creating a **simplified presumptive system of taxation** with a lower rate of tax and which reduces compliance cost, such as bookkeeping and reporting on standards by small businesses, as well as the net tax burden. This should be further complimented by increasing benefits accrued from personal tax exemptions, as most small businesses in this sector are small entrepreneurs.

In the member countries of the EAC, the challenge of designing an ideal harmonised presumptive system of taxation is further compounded by the fact that there is no commonly accepted definition of MSMEs. They are mostly defined on the basis of the size of the employee and their turnover, which manifests in different tax policies for the MSMEs throughout the EAC. Thus, some businesses may qualify as an MSME in one of the member countries, while the same firm can be categorised as a large firm in another member country. Harmonisation also poses the challenge of balancing integration and maintaining sovereignty. Especially in the EAC, certain taxes, like excise, may be justified on certain products consumed by the population for reasons of revenue based on the different cultural background and preferences, which might not be the case in the other member states.

Therefore the way forward for the EAC Partner States to design a harmonised presumptive system of taxation should firstly prioritise incorporating as many taxpayers into the formal sector as possible. Also, the presumptive taxation regime should be such which promotes voluntary compliance of these taxpayers. Later, after the system has been established and implemented, it should be placed under permanent review.

As discussed, the best approach for the Partner States of the EAC would be to adopt a simplified presumptive system of taxation in lieu of standard taxation. In this situation, the members can choose from the different categories of presumptive taxation to best suit their differing needs and characteristics of small businesses. Presumptive system of taxation can be based on: 1)

turnover or gross income, 2) indicators, and 3) lump sum patents.

Presumptive tax system based on the turnover or gross income is the best alternative, which could either be applied to the turnover of the business at a uniform rate, as a progressive tax, and also at different rates on a standardised tax base. Small firms greatly benefit from this system because they do not incur any tax burden when they are faced with a period of below average volume of transactions. The turnover based system also mandates basic bookkeeping obligation for small firms, a good example of this is Tanzania, which facilitates the future transition towards formalisation of these businesses. Since the system is a better measure of profits than the indicator system, the turnover system is best suited for MSMEs, both trading and services, which have a turnover under the value added tax (VAT) threshold.

The indicator system on the other hand, which taxes businesses based on indicators, such as size of business, number of employees, value of inventory etc., can have adverse effects on employment generation or capital use, as businesses would try to limit their scope to avoid being taxed. Although the indicator based system is not as ideal as the turnover system, a combination of the turnover and the indicator system can reduce the scope of tax evasion in the EAC. Hence, along with the turnover system, the indicator system can be used in the EAC especially for small number of businesses above the VAT threshold which run a particular risk of tax evasion.

The lump sum patent system is the least sophisticated of all as it imposes a uniform tax

Table 1: Taxation in the Partner States of the EAC

	Burundi	Kenya	Rwanda	Tanzania	Uganda
<b>Personal Income Tax</b>					
Tax Free Income Threshold (US\$ approx)	400	700	-	-	-
Tax Rates on Taxable Income (US\$ approx)	27% to 60%	-1600: 10% - 3110: 15% - 4620: 20% -6130: 25% over 6130: 30%	- 640: 0% - 2120: 20% - over 2120: 30%	-900: 0% -3250: 15% -4870: 20% -6490: 25% over 6490: 30	-750: 0% - 1350: 10% -2380: 20% over 2380:30%
<b>Value Added Tax</b>					
Supply of Imported Goods and Services	18%	16%	18%	18%	18%
Export of Goods and Services	0%	0%	0%	0%	0%
<b>Excise Duty (Selected)</b>					
Gasoline	n/a	US\$0.38/litre	76%	US\$0.26/litre	US\$0.41/litre
Kerosene	n/a	US\$0.10 /litre	76%	US\$0.04/litre	US\$0.10/litre
Cellular Phone Services	n/a	10%	5%	10%	12%

Source: GTZ 2009

**Table 2: Types of Business to Integrate the Informal Sector**

	Type of Business	Appropriate System
1.	Micro-businesses, MSEs without fixed business location and subsistence level SME	Simple Patent
2.	MSME with turnover below VAT threshold, which includes standard MSMEs in trading and service business	Turnover Based System
3.	SMEs, above VAT threshold, with particular high risk of turnover evasion (transport sector, gambling establishment, catering etc.)	Indicator Based System
4.	Other SMEs above the VAT threshold	Standard Tax Regime with simplified bookkeeping and return filing options

Source: IFC 2007

irrespective of size and turnover. The aim of the patent system is not the generation of revenue but to familiarise the micro businesses to pay taxes. Table 2 provides options for choosing the appropriate systems that could be adopted for different types of businesses to integrate the informal sector.

### Conclusion and Recommendations

The choice of the appropriate system of taxation is essential in the EAC, based on the needs of small businesses. The key requirement of designing the system is to avoid the overlap of the presumptive tax system with the standard, while at the same time operating in lieu of various central and state taxes to reduce compliance. While choosing between different categories of the presumptive tax system for small

businesses, the Partner States should try to harmonise the presumptive tax systems in a manner which is well coordinated with the standard tax regime to avoid any conflict of rules. This would remove obstacles and facilitate the movement of businesses from one system to another.

It is also recommended that while applying the presumptive system of taxation, it should be limited only to small businesses operated by individuals. At the same time, particularly for the turnover system, there should be a differentiation between traders and service providers, as they have different profit margins as percentage of their turnovers. The system should also ideally allow businesses which can comply to opt out of the simplified system and be taxed according to the standard system. This is important for loss making MSMEs and small businesses with a lower profit margin, than the margin presumed by the simplified system. Start up businesses should be provided with a guaranteed incentive of no tax burden before their official registration. Tax amnesty should be granted to those businesses registering voluntarily. All these efforts have to be complemented by taxpayer awareness and education programmes to reach the MSMEs.

Finally, it should be borne in mind that tax compliance is not only enhanced by formulating good policies and enacting tough legislation. There exists a strong relationship between the goodwill that people have on their government and tax compliance. Harmonisation of tax policies and design of a tax regime suitable for MSMEs is therefore simply necessary but not a sufficient condition to improving tax compliance in the MSMEs. The socio-economic and political issues also have to be addressed alongside to achieve better results.

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