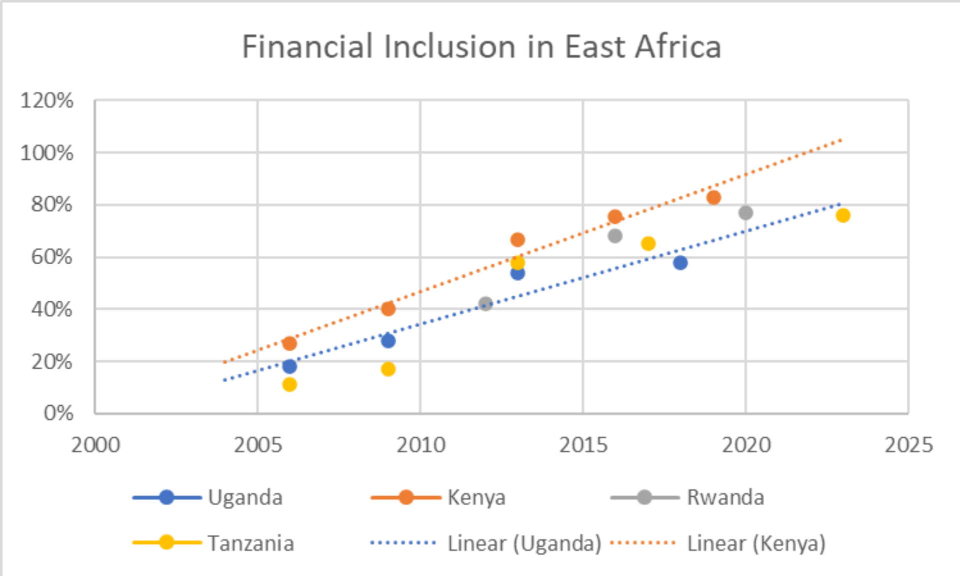
Financial Inclusion and the Taxation of Mobile Money

David Cracknell



Source: Finscope and FinAccess Reports

This blog draws heavily, but not exclusively on experience from Uganda in thinking through the relationship between financial inclusion and the taxation of mobile money. It suggests that for many economies a greater focus on consumer behaviour is required to explain the collective impact of taxing mobile money on the nature and extent of financial inclusion.

Mobile money and digital finance has driven financial inclusion throughout East Africa, alongside innovations such village level Umerenge SACCOs in Rwanda. Rwanda reports formal financial inclusion at 77% (2020)[i], Tanzania 76% (2023)[ii], Kenya at 84% (2021)[iii]. However, Uganda appears to buck the trend with financial inclusion at 59% (2018)[iv]. Financial inclusion appears to be increasing, but at a much lower and slower rate.

I start by thinking through the lower level of financial inclusion in Uganda through two lenses. Firstly, through the lens of ecosystem development and secondly through the lens of consumer behaviour. Thereafter, I consider the potential impact of taxation policy on national priorities for financial inclusion and the move towards a cash-lite economy.

Ecosystem development

Cracknell and Wilkinson (2022)[v] in a blog on "fintech generations" consider how a digital ecosystem develops, through five stages, which are broadly:

1. Scaling up: through agents providing cash-in and cash-out and facilitating account opening.
2. Driving volume and value: through 'use cases,' which differ from market to market.
3. Development of a fintech industry and a supportive regulatory environment
4. New types of financial services: Financial services embedded in solutions which fit consumer or business lifestyles.
5. Fintech as a national asset: Where specific national policies are developed towards the fintech sector in immigration, education, capital, taxation and supporting innovation are developed.

In the fintech generations approach, each stage is not completely distinct, but each stage contributes to the success of future stages, and therefore, the development of the digital finance ecosystem. Similarly, failings and challenges at each stage impede the development of the digital finance ecosystem.

Uganda started mobile money in March 2009, but only launched agent banking in 2018, compared to 2007 and 2010 respectively in Kenya. Whilst agents grew rapidly, take up was slower than in Kenya. This is partly due to the late launch of digital identity which started to roll out only in 2014. Until digital identity was launched and the launch of agent banking it was difficult and time consuming to open a bank or mobile money account. There were far fewer bank accounts in Uganda than in Kenya relative to the population.

In contrast to Uganda, the number of accounts and agents quickly grew in Kenya. With an existing national identity, it was easy and quick to open a mobile money or bank account through an agent. Safaricom quickly linked bank accounts with mobile wallets which facilitated the growth of merchant services as M-Pesa users could top up their mobile money accounts from their long-term store of value (their bank accounts) without resorting to a 'cash-in' transaction. With a large user base, digital credit services grew, and volumes of transactions increased exponentially.

The growth in users and transactions, combined with wallet-bank linkages to create an increasingly interoperable system which stimulated the growth of the fintech industry, making Nairobi one of Africa's leading fintech destinations.

By contrast, this ecosystem was much slower to develop in Uganda, policy on interoperability evolved, but was not fully implemented, bank-wallet linkages were made, but were far from universal, coverage expanded, but more slowly than Kenya.

Despite challenges in developing the digital finance ecosystem, an ecosystem approach only partly explains a slower growth in financial inclusion in Uganda, part of the answer lies in consumer behaviour.

Consumer behaviour

Uganda is a cash economy, in 2019 there were only 1m registered taxpayers compared to 1.7m in neighbouring Kenya[vi]. A small taxpayer base likely contributes to higher marginal tax rates for income tax and VAT in Uganda than in neighbouring countries.

Many Ugandans operate one or more informal cash-based enterprises, often with limited formal record keeping. Businesses grow, but not necessarily to the level where they are required to formalise. In some cases, an entrepreneur opens a new business line rather than formalise their main business activity and subject themselves to taxation.

There is a high perception of corruption, with Uganda recorded by Transparency International in 2022 as more corrupt (142/180) than Kenya (123), Tanzania (94) or Rwanda (55)[vii]. Levels of trust in the public sector are low, 46% of Ugandans reported having paid a bribe to a public servant in the last year. Informality combines with low levels of trust, and a desire to keep transactions out of the tax net. Even wealthier Ugandans invest informally through building property or through investing in agricultural assets such as eucalyptus plantations – again often based around cash transactions.

In 2013, the URA requested changes to the Finance Act to facilitate the URA investigating bank accounts. The then Executive Director of Centenary Bank – Simon Kagugube, said at the time. "*People will resort to keeping money under their mattresses if this measure takes effect. URA can explore other ways to make taxpayers honour their tax obligations*"[viii]. Then in 2018 the Uganda Revenue Authority issued blanket notices requesting financial institutions to submit records on their customers to assist in tax investigations. These measures were successfully challenged by 30 banks[ix], where the court ruled that the URA could not issue such notices without probable cause. However, by then damage to perceptions of fairness and transparency had been done.

There are several perceptions which are likely to be operating in these circumstances:

a) That transactions which can be traced can indicate business transactions (values and volumes) which can queried and taxed.
b) Assets which are valued and later sold can result in tax liabilities.

Therefore, preferences for cash for many transactions are strongly entrenched. In this context, taxation of mobile money likely enhances preferences for cash.

<u>Taxation of mobile money</u>

Taxation of mobile money takes several forms. Taxes can be applied on fees and commissions - these taxes are relatively common. However, in some countries, Ghana, Tanzania, and Uganda for example, the value of transactions has also been taxed. In Uganda, on 1st July 2018 a 1% tax on the value of transactions was imposed, which was reduced to 0.5% on 19th July 2018 after a strong public reaction against the tax. In addition, on 1st July 2023, agents are to pay a 10% commission on the fees they earn.

The nature of taxation creates or reinforces perceptions and provides incentives for individuals to change behaviour. The perceptions include that mobile money transactions are being recorded and by extension are being watched, and possibly analysed by tax authorities. Secondly, there is a direct price incentive to change transactions away from the taxed channel to channels which are not being taxed, either back to cash, or through a bank transfer or cheque. In Tanzania primary research[x] showed that taxation of mobile money transactions creates the perception that mobile money is expensive, and therefore a service to be used selectively.

Certainly, the nature of transactions has changed since the taxation of mobile money. The GSMA studied the impact of taxation in Tanzania[xi] and made conclusions:

a) Effective fees on transactions (including taxation) had increased by as much as 369%.
b) Transaction volumes and transaction values dropped by 25%
c) The value of transactions fell against a previously rising trend by 12%.

UNCDF conducted a study on the taxation of mobile money in Uganda[xii], and noted that the average transaction size dropped from UGX.54,000 in Q2 2018 to UGX 29,000 in Q4 2018, reflecting higher value users shifting transactions away from mobile money. In some cases this would have been higher value users shifting transactions towards agent banking transactions which were not taxed in the same way.

<u>Taxation of the Digital Economy</u>

This doesn't mean that the digital economy shouldn't be taxed, rather that taxation needs to be considered through a behavioural lens, and that the tax paid whilst generally disliked is perceived to be 'fair' or at worst perceived to be 'unavoidable' in the normal course of business.

There are several examples of 'smarter' taxes from Kenya. Firstly, Uber drivers are charged a final tax of 3% of their journey fees, if the assumption is made that Uber drivers make a net profit of 10% of their commissions, this equates to an effective tax rate of 30% which is comparable to income taxes and corporation taxes. Secondly, Kenya introduced a digital services tax of 1.5% of transactions value for businesses deriving income through a digital marketplace (e-commerce)[xiii]. Thirdly, 137 betting companies in Kenya are set to remit betting taxes on a real time basis through M-Pesa[xiv].

National Priorities for Financial Inclusion and Cash-lite.

The impact of Covid-19 and the direct and indirect impacts of the war in Ukraine have decreased revenue from donors and decreased economic activity, increased inflation, and depressed domestic taxation. Raising taxation has become an imperative across East Africa, and in particular Kenya, which has the additional difficulty of a falling exchange rate due to international debt in dollars and Euros coming due in 2023 and

2024. However, how digital taxes should be raised needs to be carefully considered and weighed against potential negative impacts.

Cash lite implies:

a) Lower costs in printing and distributing cash.
b) A change in risks and fraud around cash vs. digital money.
c) Improved traceability of transactions
d) Reduced potential for AML/CFT due to traceability
e) Increased diversification of the economy and the potential for the introduction of 'smart taxes.'

Analysis by Central Banks or econometricians with access to information on the cost of cash, the changing nature of fraud, the impact of AML/CFT are in a better position to estimate the value of a digital economy and to estimate the true cost of taxation which likely slows the adoption of digital finance and by extension, slows rising levels of financial inclusion.

Kenya is evolving more rapidly towards cash-lite than in Uganda or Tanzania. It can be argued that this is in part due to the level of ecosystem development combined with different behavioural incentives or disincentives for using or not using mobile money. These behavioural incentives and disincentives are strongly influenced by the price of services which are influenced by taxation, but also by perceptions of the fairness and/or appropriateness of the taxation being charged. By contrast the perception that the formation of a digital data trail may lead to future taxation is only likely to be enhanced by the taxation of the value of mobile money transfers.

Clearly the taxation of mobile money needs to be further studied from a behavioural perspective. However, 'smarter' taxes which are perceived as fairer, or at worst a necessary cost of doing business, need to be devised wherever possible.

This blog is one of a series of blogs, please comment, should you wish to sign up to receive additional blogs, please write to David Cracknell at david@firstprinciples.consulting or register on www.firstprinciplesinfinance.com

David Cracknell is the Director of First Principles Consulting Limited, based in Nairobi, Kenya. He advises financial institutions, governments, policy makers and donors on financial services, including digital finance, policy and regulation, and inclusive finance.

---

[i] AFR (2020), "Finscope Survey 2020 Report", AFR, available on https://afr.rw/downloads/finscope-survey-2020-report/

[ii] FSD Tanzania, "Finscope Tanzania 2023 Report – Key insights", https://www.fsdt.or.tz/wp-content/uploads/2023/07/Finscope-Tanzania-2023-Report-Key-Insights-One-Pager.pdf

[iii] FSD Kenya, "FinAccess Household Survey 2021", FSD Kenya, available on https://drive.google.com/file/d/1WJ9DuOQoGKZ0FtbEKAhANEgqh3p0LbNo/view

[iv] FSD Uganda, "Finscope Uganda Survey Report 2018", available on https://fsduganda.or.ug/wp-content/uploads/2018/10/FinScope-Uganda-Survey-Report-2018.pdf

[v] Cracknell David and Betty Wilkinson (2021), "Fintech Generations" (blog) First Principles Consulting, https://firstprinciplesinfinance.com/blogspot/f/fintech-generations

[vi] Monitor (2021), "Only 1million Ugandans are paying taxes, says URA", Daily Monitor, available on https://www.monitor.co.ug/uganda/business/finance/only-1-million-ugandans-are-paying-taxes-says-ura-3436800

[vii] Transparency International (2022), "Corruption Perceptions Index", Transparency International https://www.transparency.org/en/cpi/2022?gclid=Cj0KCQjwqs6lBhCxARIsAG8YcDgINSazEzzux0Vc3bypkfTjKo68m4EnDwEQO17v2wlrUW-mzm0QCmsaAvt7EALw_wcB

[viii] Daily Monitor, "Taxpayers Against Law to Grant URA Access to Bank Accounts", available on https://www.monitor.co.ug/uganda/business/finance/taxpayers-against-law-to-grant-ura-access-to-bank-accounts-1545112

[ix] Daily Monitor, "Could URA's Demand For Bank Account Details Have Been Handled Better?" https://www.monitor.co.ug/uganda/oped/letters/could-ura-s-demand-for-bank-account-details-have-been-handled-better--4163710

[x] AERC Kenya (unpublished) – forthcoming paper.

[xi] GSMA (2022) "Tanzania Mobile Money Levy Impact Analysis, GSMA, available on https://www.gsma.com/publicpolicy/wp-content/uploads/2021/12/spec_tanzania_mm_report_02_22-1.pdf

[xii] UNCDF (2021), "Mobile Money Taxation in Uganda", UNCDF, available on https://www.uncdf.org/article/7313/the-impact-of-mobile-money-taxation-in-uganda

[xiii] Business Daily (21st January 2023) "KRA nets Sh.147m in Digital Services Tax in Six Months" available on https://www.businessdailyafrica.com/bd/economy/kra-nets-sh174m-in-digital-service-taxes-in-six-months--4096648

[xiv] Business Daily (18th April 2023) "137 Online Betting Companies set to remit taxes to the KRA via MPesa under new system", Business Daily https://www.businessdailyafrica.com/bd/corporate/companies/betting-firms-set-to-remit-taxes-via-m-pesa-under-new-system--4202656

FIRST PRINCIPLES CONSULTING

42 Riverside Drive
Nairobi
Box 76436 - 00508
Kenya
+254-733-713380

davidjcracknell
david@firstprinciples.consulting
@davidjcracknell
www.firstprinciplesinfinance.com