

TAX ADMINISTRATION AND TAX REFORM: REFLECTIONS ON THE TANZANIA EXPERIENCE 1986-1996

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Abstract

This paper attempts to make a factual assessment of the impact of the substantial efforts made to reform the tax system in Tanzania over the period 1986-96. Specifically, our main objective is to assess the effect of the key elements of the tax reform, namely, rationalisation of the tax structure, reorganisation of the tax administration machinery, and strengthening tax collection, on tax revenue performance. This paper employs various measures of tax revenue yield to show that the tax reform measures did not safeguard the productivity of the tax system. In spite of the significant improvements in tax administration, individual tax performance remained mixed while the overall tax-GDP ratio declined. Bouyancy ratios also corroborate the low tax productivity trends. The unsatisfactory tax performance is attributed to weaknesses in tax administration, manifested in the prevalence of leakage of government revenue. The latter is indicated by the low import duty collection ratios compared to the average scheduled tariff rates, the significant magnitudes of under-invoicing of imports derived here, and sizeable exemptions. In order to improve the productivity of the tax system in the next decade, the paper suggests that the next phase of the tax reform programme should focus on the following key elements: further rationalisation of the tax system concurrent with stronger enforcement measures; registration of taxpayers; establishing the potential tax bases; prompt introduction of VAT as planned; effecting higher remuneration to the middle level cadre of the TRA staff; eliminating tax exemptions altogether; and widening the tax base by sealing the major leakages in government revenue.

1. Introduction

Taxation and tax administration remain matters of great interest and importance to society for many reasons. Taxpayers on their part generally view taxation to be a necessary evil. It is necessary in the sense that tax revenues stand as the main determinant of the volume and quality of goods and services provided by the government to its citizens. These include: maintaining law and order; maintaining macroeconomic stability and laws or regulations in support of private economic activity; investing in human capital, that is, education and health services; investing in and maintaining infrastructure such as roads, railways marine ports and airports; and other public amenities. However, taxation is also unpleasant, considering that it reduces the welfare of every member of society who gives-up part of his or her

the impact of the tax reform measures on the productivity of the tax system. The findings are used in turn to outline the direction for further reform of the tax system. However, the discussion here is limited to central government taxation only. The rest of the paper is structured as follows. After this introduction, section two puts into perspective Tanzania's tax reform experience over the past decade (1986-1996) focusing on achievements and failures. Section three discusses some major areas of concern and unfinished business. These include, tax evasion, the controversial issue of investment reliefs and incentives schemes; the planned introduction of VAT; and administrative concerns particularly the role of the Pre-shipment Inspection (PSI) of imports. The fourth and final section proposes the key elements of the next phase of the tax reform programme.

2. Tax Reform Experience 1986 - 1996

Since June 1986 when Tanzania's Economic Recovery Programme started, the tax revenue yield has been inadequate. This is indicated partly by the fact that the growth in tax revenue has continued to lag behind the GDP growth. Even the remarkable improvements in tax collection which were registered during TRA's first year in operation seem to have lost steam as tax arrears diminished. Consequently, Tanzania has continued to live with unsustainable fiscal deficits, and forced the government to resort to the monthly cash budget system to curb over expenditure. The low tax-productivity can possibly be explained by the inability of the tax administration machinery to capture the fast-growing informal sector and small holder agriculture into the tax net. The other reason relates to the failure to seal the leakage of government revenue through both fraudulent tax evasion and exemptions.

Table 2: Buoyancy of Tax Revenue with Respect to GDP by Type of Tax

Year	customs duty	Excise (Imports)	Excise (Local)	Sales tax (Imports)	Sales tax (Local)	Income tax	Other taxes	Overall Buoyancy
1988/89	1.34	-	-	1.52	1.08	2.26	1.10	0.55
1989/90	1.31	-	-	0.42	-0.85	-0.33	1.73	1.45
1990/91	1.48	1.44	1.34	0.62	1.25	1.59	1.14	1.01
1991/92	0.77	-0.10	1.88	1.10	0.39	0.59	2.54	-0.02
1992/93	-1.07	-1.74	-1.64	-0.28	-0.41	0.52	1.36	-0.19
1993/94	2.11	-0.20	1.51	1.58	1.69	0.98	2.18	1.57
1994/95	1.78	5.20	-0.80	1.62	0.58	1.41	0.65	1.11
1995/96	1.13	2.59	2.91	0.41	-0.04	0.76	1.08	1.03

¹ The buoyancy has been estimated by the following formula (Tanzi, 1981):

$$b = \frac{T_t - T_{t-1}}{Y_t - Y_{t-1}} \div \frac{(T_t + T_{t-1}) / 2}{(Y_t + Y_{t-1}) / 2}$$

Where,

b = year-to-year buoyancy

T = tax revenue

Y = GDP at current prices (average for the corresponding calendar years)

t = current year

t-1 = preceding year

Available data also indicate that the relative importance of the various taxes has shifted away from being dominated by domestic indirect taxes to international trade taxes (Figure 4). The share of sales tax and excise duty on locally produced goods together declined from an average of about 32 percent for 1992/93 -1993/94 to 25 percent for 1994/94 -1996/97.

The observed shift in the relative weights in total tax revenue away from domestic taxes reflects the consolidation of sales tax rates as well as the reduction in the number of locally produced excisable commodities. Conversely the share of foreign trade taxes increased from about 22 percent to 32 percent over the same period. The increase in the relative contribution of foreign trade taxes is essentially a result of administrative measures taken to improve customs collections. These

taxes but slackened in the case of domestic taxes. It is also fairly apparent that the reform measures and especially the reductions in the tax rates, which were aimed to induce higher compliance rates, did not safeguard tax buoyancy or revenue performance. In the section that follows we attribute this apparent dilemma to inadequacies in tax enforcement.

3. Major Areas of Concern

3.1 Tax Evasion

One of the most stubborn problems that faced the then tax departments and continues to haunt the Tanzania Revenue Authority (TRA), is the prevalence of leakage of government revenue. Even though the TRA has taken measures to strengthen import tax assessment procedures, monitor closely the operations of customs bonded warehouses and transit trade, these measures remain inadequate as indicated by seemingly undeterred tax evasion.

For example, Table 3 below presents some estimates of aggregate under-invoicing of imports derived as the residual of export (c.i.f) data of supplying countries compared to local import (c.i.f) data. It is fairly clear that under-invoicing of imports in fact increased over the reform period notwithstanding the use of the pre-shipment inspection of imports. Notice that under the simplifying assumptions made in estimating the amount of import duties evaded, and invoking an exchange rate of Tshs. 600 to 1 USD, the amount of duty evaded is equivalent to 90 percent of the actual import duty collection (Tshs. 61,271.4 million) for 1995/96.

sample of 50 taxpayers. On average, under-declarations of taxable incomes were 48% in 1993, 47.5 percent in 1994 and 65 percent in 1995.

Evasion of withholding tax is also substantial. For example during the period March-June 1997 the number of defaulters was 927 besides 478 dormant ones compared to only 449 live withholding taxpayers. Withholding tax on goods and services is apparently the most evaded tax and notoriously so by private companies. The amounts involved are also substantial. For example during 1996/97 alone, over 3 billion shillings was recovered by TRA through an audit of only 412 select cases. Analogously, rental income tax is undoubtedly one of the most evaded taxes. In spite of the paucity of data few will disagree with the fact that the real estate sector in Tanzania is an important source of income but its contribution to government revenue is not proportional. The problem is that this is one of the hard-to-tax sectors. It is common knowledge for example that some houses along Mbezi beach in Dar es Salaam are rented at prices ranging from USD 1,500 - 2,500 per month and mostly by foreign international agencies who are unfortunately reluctant to disclose their rental transactions.

The reasons which fuel tax evasion in Tanzania are many. These include: vague tax laws which are subject to various interpretation; problem of too many taxes and imposition of prohibitive tax rates on few taxpayers or commodities; weak and cumbersome tax collection procedures; shortage of skilled workers; poor remunerations (especially for the middle level category of the TRA staff) and tools for the tax collectors; lenient penalties for the tax evaders; and rampant corruption (Ndulu 1996, Sanare 1996, Warioba Commission Report 1996, Mpango 1996); and lack of transparency in tax administration (ESRF 1996).

the potential tax base. Unfortunately, the tax reform drive in Tanzania seems to have given more push to the former, and in a piecemeal fashion, under pressure from the Business Community, but less on the latter equally important front. The introduction of the personal identification number (PIN) system is also still on the drawing table. Moreover, even a base which is presumably easier to quantify, such as the 'true' volume of imports, remain contentious. For instance in 1996 the Business Community estimated that the most realistic estimate of the country's imports was US\$ 2.6 billion as against the official figure of US\$ 1.5 billion (ESRF, 1996). It is also important to observe that while some positive steps have been taken to remunerate the TRA employees reasonably (notably at the managerial level), this has not trickled down to the middle level personnel who actually deal with the taxpayers daily. To compound the problem, the TRA contract - based employment policy has the undesirable effect of creating a high job insecurity for the TRA employees. In turn, inadequate remuneration and high job insecurity combine to make a very fertile ground for the prevalence of corruption and tax evasion.

3.2 The Challenge of Widening the Tax Base

Taxation experts on Tanzania generally agree that the tax base of Tanzania is narrow and shallow, and that a more permanent solution toward a high yielding, low tax, equitable and efficient tax system, is to work to broaden the tax base. The intricate question has, however, remained how to do so. In principle, there are many ways of widening and deepening the tax base. One is obviously to introduce new taxes, that is to levy taxes on a newly determined base. A good example is the value added tax (VAT) scheduled for introduction in July 1998. The other could be to reach,

Overall, during 1994/95 and 1995/96, total exemptions amounted to 123 billion shillings. Of this total, 72.7 percent were awarded to, non government institutions, private companies and individuals and by the IPC. If one goes by type of tax, the bulk of the exemptions (98 percent) are made up of sales tax and import duty. Considering that the actual tax collections from imports for 1994/95 and 1995/96 were 212.5 billion shillings, it implies that exemptions were equivalent to 58 percent of the actual taxes collected from foreign trade. This is certainly no small amount and substantial savings can be gained by slashing down exemptions to the minimum.

Admittedly, abuses of statutory exemptions have been reduced since TRA began operating, but there is still room for further reductions. In particular, the Minister for Finance should, in accordance with the law, strictly and solemnly follow recommendations by the TRA regarding whether or not to grant exemptions, and only when national security is really at stake. In addition, the large amount of donor-financed project imports needs stringent scrutiny by the TRA and verification by the pre-shipping inspection companies. An important step in widening the tax base should also involve subjecting all imports and other purchases by government departments and agents to taxation to curb abuses of this avenue. Other exemptions such as on printed matter, paper and paper board, agricultural machinery and appliances, and many more, should, in our opinion, be discarded.

3.2.2 Investment Reliefs and Incentives

The Income tax Act, 1973 provides for a number of reliefs, including a 20 percent deduction for the cost of investment in preferred sectors (agriculture, mining, manufacturing, tourist hotels and ships). Selective tax exemptions can also be given at

the cost of policing such exemptions. As already indicated in Table 4 above, the magnitude of revenue foregone by way of IPC exemptions alone are overly high and perhaps difficult to justify. The estimated income tax reliefs from IPC exemptions are also high and range between 7 and 8 percent of actual company tax revenue.

The euphoria to introduce tax incentives in response to any new or promising investment in Tanzania therefore needs serious rethinking. Certainly, a thorough review of the investment reliefs and incentives constitutes another potential area for widening the tax base. However, the problem is that very generous exemptions have already been granted and there are difficulties of revoking them ex-post. Yet, these incentives have serious flaws. As Boskin and McLure 1990 point out, often such devices end-up stimulating one investment with a low social rate of return but lead to the rejection of other investments with much higher social rates of return. It would certainly makes more sense to consider giving reliefs to the present value of the expected income stream from an investment (reducing income tax) rather than subsidising outlays of such investments. The government could at least do two things. One, suspend the IPC investment incentives for new projects while working to put in place the factors that matter most in terms of attracting investment. Two, make an attempt to verify and reconcile imports exempted under IPC with investments produced with such imports, given the difficulty of rescinding the exemptions already granted.

3.2.3 Planned Introduction of the VAT

The planned introduction of VAT in Tanzania in July 1998 is not only feasible but desirable, and therefore ought, in my judgement, to be vigorously pursued. The VAT stands to emerge as the largest revenue source and reduce the current

administrative requirements. In the interim, the minimum level of record keeping of sales and purchase invoices should be legislated and popularised.

3.2.4 Other Administrative Concerns

One issue which perhaps, requires a review relates to the performance of the Pre-shipment inspection (PSI) of imports, that has been in operation since October 1992. The PSI agents have certainly played some useful role, particularly in terms of availing to the Customs information on shipments, which has subsequently been used for tax enforcement. The PSI agents also employ a number of Tanzanians in some of their operations.

However, pre-shipment inspection of imports is not without flaws and the performance of these PSI agents has not been unambiguous. For example, as indicated in Table 1, import duty collection ratios have remained low and even declined in some years, notwithstanding the engagement of the PSI companies. Similarly, the growth of customs duties did not move in tandem with the growth in imports. In fact the correlation coefficient between the two is negative (-0.5) for the period 1991/92 to 1995/96. By the same token, the PSI companies have apparently not helped to curb under-invoicing of imports. Measures of under-invoicing of imports derived in Table 3 above show that the faking of imports have actually increased. In addition, the prevalence of sub-standard foreign goods in the Tanzanian market (food unfit for human consumption, expired drugs, and so on), suggest that the PSI companies have also not been successful in checking the quality of imports entering Tanzania. The costs of these PSI companies to the taxpayers are significant as indicated by the magnitude of the inspection fees paid (estimated to be 4 billion Tanzania shillings for 1995/96 alone, which is equivalent to 0.95 percent of half the total value of imports

members of parliament and other political figures), to the large number of known but dormant taxpayers.

As regards other tax administration dimensions, the TRA needs to continue to develop its personnel and institutional capacity to collect taxes in a co-ordinated and properly sequenced manner. Besides basic and specialised training in tax policies, procedures and regulations, it is imperative that TRA introduces the PIN system as soon as possible and also continue with the computerisation of its departments. The latter is necessary in the development of sound information systems to assess, collect, monitor and forecast tax revenues and tax bases.

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