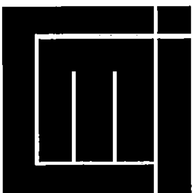
Value-Added Taxation in Tanzania?

Odd-Helge Fjeldstad

WP 1995: 5



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Summary:

Is Tanzania ready for a value-added tax (VAT)? The purpose of this paper is to answer this and other related questions that are often asked about value-added taxation in developing countries, to consider how a VAT might be implemented in Tanzania, and to discuss possible obstacles and alternatives.

Sammendrag:

Er tiden moden for å introdusere merverdiavgift (VAT) i Tanzania? Formålet med dette notatet er å drøfte dette og andre spørsmål vedrørende bruk av merverdiavgift i utviklingsland. Problemer knyttet til implementering av VAT i Tanzania og mulige alternativer drøftes.

Indexing terms:	**Stikkord:**
Value added tax	Merverdiavgift
Taxation	Skattlegging
Tax reforms	Skattereformer
Tanzania	Tanzania

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Contents

1 Introduction and overview 1

2 An ABC of VAT 2
- 2.1 Features of the VAT 3
- 2.2 Comparing VAT and sales tax 4
- 2.3 Alternative types of VAT 5
- 2.4 Principles of implementing VAT 7

3 Structural issues of VAT 9
- 3.1 The rate structure 9
- 3.2 The base 12
- 3.3 Treatment of services 13
- 3.4 Legal and administrative features 16

4 Complications in applying a VAT 17
- 4.1 Income distribution 17
- 4.2 Administrative complexity and tax collection costs 18
- 4.3 Inflationary effects 19

5 Value-added tax in Tanzania 20
- 5.1 Principles of a VAT in Tanzania 20
- 5.2 The VAT base and rates 21
- 5.3 VAT administration 23

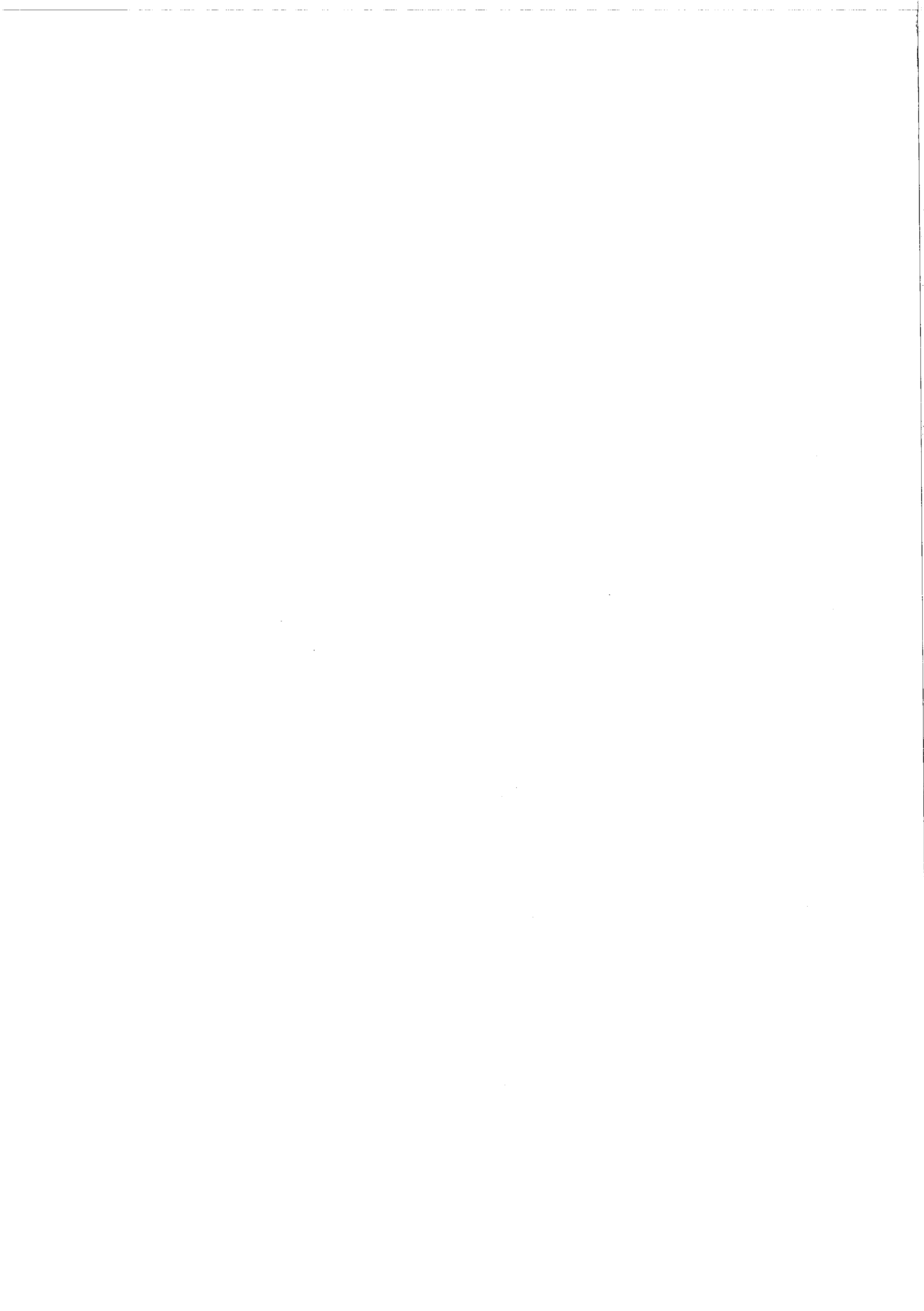
6 Conclusion: Should Tanzania introduce VAT? 24

References 26

Tables

3.1 VAT rates in selected countries 11

3.2 VAT revenue and base in selected countries 15



1 Introduction and overview[1]

In December 1991 the Tax Commission, appointed by the Government of Tanzania, offered a proposal for reform of the Tanzanian tax system.[2] The replacement of the current sales tax by a value-added tax (VAT) is the Tax Commission's central recommendation in the domain of indirect taxation (URT, 1991a: chapter 12). With sales and excise taxes on domestic goods and services being the largest single source of tax revenue (Fjeldstad, 1995b), this proposal implies that VAT is regarded as the mainstay of Tanzania's future revenue system. The Government announced in the 1992 (June) Budget Speech its intention to introduce VAT in January 1994. To this day, however, little progress has been made in this area.

It is not entirely clear how the introduction of a value-added tax became an issue in the Tax Commission's report. It appears that the Government and its representatives in the Commission, were committed to the introduction of VAT, apparently with the argument that a VAT would contribute to an over-all increase in tax revenue for the state. Basu and Morrissey (1993: 19) report that it is "clear that the International Monetary Fund (IMF) to some degree supported, if they did not actually initiate, this policy objective". Although several members of the Commission were opposed to introducing a VAT, largely because it was seen as administratively difficult to implement and no obvious improvement of the existing system, these reservations were not explicitly expressed in the report.[3]

Is Tanzania ready for a value-added tax? The purpose of this paper is to answer this question, to discuss possible obstacles and alternatives, and to consider how a VAT might be implemented within the constraints identified. I begin this paper by giving a brief description of the evolution of the use of value-added taxation around the world and continue by describing how VAT works. The focus in section 3 is on four major structural issues which have to be considered when

[1] This paper is based on a study commissioned by the Macro Group in Dar es Salaam, whose members are drawn from the National Planning Commission, Ministry of Finance, Bureau of Statistics and Bank of Tanzania. I would like to thank members of the Macro Group, in particular, L.T. Msongole and B.A. Shallanda, for their hospitality and support. I would also like to thank Arild Angelsen, Ibrahim Lipumba, Hildegunn Nordås, Ussif Rasid Sumaila and Inge Tvedten for many helpful comments on an earlier draft of this paper, and to the Norwegian Agency for Development Support (NORAD) and the Research Council of Norway for financial support. The usual disclaimer applies.

[2] The "Commission of Enquiry into Public Revenues, Taxation and Expenditure" was appointed in October 1989 to study and review the central and local tax systems and its administration, and make recommendations (see URT, 1991a; and Fjeldstad, 1995b). Here I refer to this as the Tax Commission or only the Commission.

[3] Basu and Morrissey (1993), and personal communications with members of the Commission and Governmental advisors.

introducing a VAT, i.e., the rate structure, the tax base, the handling of services, and legal and administrative features. Section 4 proceeds by discussing possible complications in applying VAT in developing countries, emphasizing effects on income distribution, administrative complexity, tax collection costs, as well as possible inflationary effects. In section 5 I return to the question of VAT in Tanzania, and discuss possible benefits as well as potential problems, including institutional and administrative limitations. In section 6 the paper is summed up and conclusions are drawn.

2 An ABC of VAT

The value-added tax is, according to Goode (1984: 157), "the most important tax innovation of the second half of the twentieth century". The speed with which the value-added-tax system has spread around the world is unmatched by any other tax in modern times. 30 years ago there was no comprehensive VAT anywhere (Shoup, 1990). In Japan, immediately after the Second World War, a short-lived VAT was implemented. In 1954 France introduced a limited VAT in the form of a wholesale-level VAT to replace a multi-stage production tax (Metcalf, 1995: 127). A comprehensive value-added tax first appeared in Brazil in 1967. This tax was designed to overcome the defects of turnover taxation and to secure a greater degree of tax coordination among the states of the Brazilian Federation (Shoup, 1990: 4). Later in 1967 Denmark became the first country to introduce a comprehensive VAT at the national level. In 1968 France merged the restricted VAT with the existing turnover tax on services and a local tax on retail sales into a single, comprehensive levy extending through the retail stage. In the following years, the VAT was adopted by the other member states of the European Community to replace their turnover taxes. Sweden, in 1969, and Norway, in 1970, enacted a VAT to replace a retail sales tax.[4]

Today, VAT is found in more than 90 countries. Of the OECD countries, only Australia and the US do not use value-added taxes. All Latin American countries now have VAT, as do several of the ex-communist countries of Eastern Europe (e.g., Bulgaria, the Czech Republic, Estonia, Hungary, Poland, Russia and the Slovak Republic). A number of African and Asian countries have introduced or plan to introduce VAT, including Côte d'Ivoire, Indonesia, Kenya, Malawi, Mali, Niger, Senegal and South Korea (IMF, 1992).

[4] The two taxes are generally considered to be about the same, except that with a VAT there are more taxpayers and a greater certainty of excluding producer goods.

2.1 *Features of the VAT*

The reasons why so many countries have adopted the VAT are usually connected with the following assumed features of the tax; neutrality, stability and flexibility, in addition to its revenue potential:[5]

- VAT is considered to be neutral with respect to foreign trade, and does not distort domestic production and distribution.
- VAT is considered to be neutral regarding the production technique that a business adopts. In other words, it makes no difference for the tax liability whether a product is manufactured with a capital- or labour-intensive technology.
- VAT is considered not to be influenced by the forms or methods by which business is conducted.
- VAT is considered to be a relatively stable source of government revenue. Since consumption as a share of GDP fluctuates little, by implication the VAT is a stable source of revenue.
- VAT is a relatively flexible tax instrument; a change in the rate translates immediately into more or less revenue. This is partly because the consumption as a share of GDP in general fluctuates little, and partly because the VAT is collected on a current terms.

In addition to the points made above, consumption taxes are often considered as an efficient means of taxation, since it is less likely to distort economic behaviour than income taxes (see Atkinson and Stiglitz, 1980; and Kay, 1990). With high marginal rates of income tax, individuals may have less incentive to work hard. With a consumption tax, the extra income is not taxed until it is spent. Consumption taxes can also be levied on a wide base. The wider the tax base, the lower rate is needed to raise a given amount of revenue. In theory, people should be taxed on everything they buy; in practice, many countries have numerous exemptions from VAT while others tax some goods at lower rates.

A VAT taxes the value-added in production through the various stages of production. Value added is simply the difference between the value of the goods and services sold and the value of goods and services purchased as intermediate inputs. Under a VAT, the sum of purchases (i.e., the value added at earlier stages) and value added by the firm itself equals (by definition) the value of the inputs (which have a full tax credit attached to them) of the next firm in the production-distribution process. As a result, the same value-added is never taxed twice; that is, cumulative effects do not occur. Moreover, at the final retail stage the sum of all values added throughout the process and, by the same token, the sum of all the differences between sales and purchases equal the consumer price, excluding tax. The final price, that is the price paid by consumers, has therefore to cover all the

[5] Gillis et al. (1990) provide a thorough discussion of VAT in developing countries.

values added at the successive stages. VAT thus provides a systematic mechanism for taxing final consumption while relieving transactions in intermediate goods. In comparison, the retail sale tax is levied only at the time of sale to the consumer. The total tax collected piecemeal under the VAT from all stages of production and distribution is equal to a tax collected on the sale from retailer to the final consumer or user, that is, a retailer-sales-tax. This equivalence has sometimes led to a VAT being termed a national sales tax (Metcalf, 1995:123).

2.2 *Comparing VAT and sales tax*

An increasing number of developing countries have converted their sales taxes to value-added taxes (IMF, 1992, OECD, 1995). From an economic point of view, there is, in principle, little difference between VAT and the retail sales tax (RST). Levied at the same rates and covering the same number of goods and services, both taxes should raise the same amount of revenues (see section 2.3). If VAT is identical to a retail sales tax, why not collect the full tax at the retail stage through a RST? While the economic effects of the two taxes would be the same, the design and administration of the taxes differ. A VAT is usually preferred for four reasons:

- the potential coverage of the tax;
- its ability to distinguish producer goods from consumer goods;
- its ability to (effectively) correct border tax adjustments; and
- its administrative feasibility.

It is sometimes argued that the different ways in which a VAT and a retail sales tax are collected may make enforcement of VAT more efficient.[6] Under a retailer sales tax system, producers, wholesalers and retailers do not pay tax when they buy or sell from one another. VAT in contrast, is paid throughout the production chain. Registered intermediaries, but not the final consumer, reclaim VAT by presenting a set of invoices to the tax authorities. This may make VAT harder to avoid. While a good is being produced, sellers have an interest in proving that they have paid the tax on their inputs in order to reduce the tax liability on their sales. With a retail sales tax system, in contrast, the burden of collecting the tax lies entirely with the final seller of the good. If (s)he fails to charge it, the tax on the whole value-added is lost. As the tax rises, the incentive to avoid it increases. By limiting such incentives governments can set VAT at higher rates than they could with retail sales tax. It is probably no coincidence that sales tax in the United States are 8 percent, on average, compared with a total OECD average for consumption taxes (including VAT) of nearer 20 percent (Economist, 1995). As a rule of thumb, it is often reckoned that 10 percent is the highest level at which a sales tax can be set without large-scale attempts at evasion.

[6] This point is, however, questionable (see section 3.4 and 4.2).

2.3 Alternative types of VAT[7]

There are three broad types of VAT:

1. *The consumption VAT.*
2. *The income VAT.*
3. *The gross product VAT.*

The gross domestic product (GDP) can be used as a starting point for illustrating the bases of the three VAT variants, and the relationship among them, since it represents the total sum of the value added in the domestic production of goods and services (Zee, 1995: 86). For illustrative purposes, I consider a two-factor (labour and capital), two-sector (private and public), open economy, where C is private consumption, I is gross investment, G_c is public expenditure on goods and services, G_w is public expenditure on wages and salaries, and (X-M) is the trade balance measured as the value of exported (X) less imported (M) goods and non-factor services. Gross domestic product then equals:

$$GDP = C + I + G_c + G_w + (X-M)$$

Gross domestic income (GDI) is the sum of factor income payments (i.e., wages for labour; and interest, profits, etc., to capital) - often referred to as the value added (V) - and depreciation (D):

$$GNI = V + D$$

The basic national accounting identity is given by:

$$GDP = GNI$$

This last equation can be stated in terms of either factor cost (i.e., exclusive of indirect taxes net of subsidies), or market prices (i.e., inclusive of indirect taxes net of subsidies).

The *gross product VAT* (P-VAT) has the broadest base of the three VAT types. It taxes all expenditures (except public sector wage expenditure, which is not taxed under any variant of VAT), on GDP if implemented on the origin principle, and on GDP adjusted for the trade balance if implemented on the destination principle (see section 2.4). Assuming that the origin principle is used, then the base of P-VAT can be expressed as

$$\text{P-VAT base} = GDP - G_w = C + I + G_c + (X-M)$$

[7] Sections 2.3 and 2.4 are based on Shoup (1990) and Zee (1995).

The tax is computed by subtracting from a firm's sales only purchases of goods that are used up currently, not purchases of machinery or other capital goods. This type of VAT is in restricted use, probably because it disallows deduction of both purchases of capital goods and depreciation, and, thus, strongly discourages investment by discriminating the use of capital goods.

The second main form of VAT is the *income type VAT* (I-VAT). Gross investment expenditure of the economy reflects the actual aggregate expenditure on capital goods in a given period. However, part of this expenditure is used to compensate for capital goods that have been consumed or depreciated. While depreciation as such is simply a bookkeeping entry and does not represent an actual economic transaction, it does affect the computation of profitability, and therefore the value added, of firms (Zee, 1995: 87). The aggregate tax base is equivalent to that for a comprehensive income tax, excluding depreciation from its base:

$$\text{I-VAT base} = GDP - G_w - D = C + (I - D) + G_c + (X\text{-}M) = V - G_w$$

The last equality in this equation indicates that the base of an I-VAT is the sum of factor income payments (net of government wage expenditure). Hence, it relies on understanding the general cash flow for a firm. This type of VAT is used, for example, by Argentina and Peru.

The *consumption VAT* (C-VAT) is the most common type. The tax is levied on the total value of sales at each stage of production and allow a credit for any VAT paid on inputs in production. Thus, in addition to depreciation, expenditures on capital goods which contribute to a net augmentation of the capital stock are not taxed. Thus, the entire gross investment expenditure is excluded from the tax base:

$$\text{C-VAT base} = GDP - G_w - I = C + G_c + (X\text{-}M)$$

The C-VAT is the most neutral of the three VAT types since it does not generate distortion in the production process between capital and other inputs. It can be considered a general tax on consumption (inclusive of net exports if implemented on the origin principle, as shown above). Providing the narrowest base of the three VAT variants, C-VAT requires the highest rate to achieve a given revenue yield.

If the trade balance (X-M) is removed from each of the three VAT bases, the VAT variants would be converted to the destination principle (see section 2.4). In this case, the C-VAT base becomes:

$$\text{C-VAT base} = C + G_c$$

This relation corresponds to the total sales tax at the retail level. Hence, a C-VAT implemented under the destination principle is equivalent to a retail-sales tax (see

section 2.2). However, the administration and collection mechanisms of the two taxes are quite different.

2.4 Principles of implementing VAT

Each of the three variants of VAT discussed in section 2.3, can be implemented under two principles - the origin and destination principles; and by using two main methods of computation - the credit-invoice and subtraction methods (OECD, 1995; and Zee, 1995).

Under the *origin principle* the VAT is imposed on the value added of all taxable products that are produced domestically. Under the *destination principle* the VAT is imposed on the value added of all taxable products that are consumed domestically (Zee, 1995: 88). The distinction between the two principles is based on the location of production and consumption, and not the type of products being produced or consumed.[8] The two principles are identical in a closed economy. In an open economy, the differences between them lies in the treatment of exports and imports. Under the origin principle, exports are taxed but imports are not, while the converse is the case under the destination principle.

Most countries that have a VAT have implemented it on the destination principle. This is due to two main reasons (Zee, 1995: 89): First, the destination principle is regarded as effective in ensuring that traded products contain no VAT elements of the exporting countries. The origin principle, in contrast, which allows imports entering a country to bear the VAT burdens of exporting countries most likely will lead to undesirable tax competition, implicating that flexible prices and exchange rates are not being viewed as adequate mechanisms for alleviating such behaviour among trading countries. Second, although the destination principle requires border tax adjustments, such adjustments can be carried out with relative ease. In any case, they seem to be a small price for circumventing the potential valuation problems associated with the origin principle.[9]

[8] This distinction is analogous to that between the residence and source principles in income taxation.

[9] The restricted origin principle is an alternative for countries that are members of a customs or economic union. If border controls on trades among union members are either absent or ineffective by default, or their removal is a stated objective of the union, the implementation of the destination principle is generally regarded as infeasible. Under the restricted origin principle, VAT divergence among union members can be overcome by a clearinghouse mechanism whereby the importer in a member country is given credit (under the credit-invoice method) for the VAT paid on his/her imports in the exporting member countries. Such foreign credits would be recorded by every union member against every other union member, and the net claims on each member would be settled by a clearinghouse (Zee, 1995: 90).

Two alternative methods are used for computing the value added of a taxable transaction under a VAT; the *credit* or *invoice method*, and the *subtraction method*.[10]

The *credit method* requires that the amount of VAT charged is explicitly stated on the invoice associated with any taxable transaction. For purposes of claiming the credit, a firm is required to show proof, usually an invoice, that the VAT has been paid by its supplier. This provides a form of self-regulation in VAT enforcement, since firms have an incentive to ensure that the VAT that their supplier claims to have paid has in fact been paid. The amount of tax a firm (or merchant) submits to the tax authorities is simply the difference between the tax collected on its sales and the tax it paid on its purchases. Since it is the consumer who bears the ultimate burden of the VAT, the merchant at each stage, in principle, acts as a tax collection agent.

Under the *subtraction method*, each firm's (or merchant's) tax liability is computed by applying the applicable VAT rate to the difference between its total sales (inclusive of the VAT element in its sales price) and its total purchases (inclusive of the VAT element in the purchase price). Hence, unlike the credit method, the amount of VAT connected with a taxable transaction is not required to be explicitly stated on the associated invoice.

If the VAT has a single rate and no exemptions and zero-ratings, the subtraction method yields the same outcome as the credit method. When the VAT contains multiple rates and extensive exemptions neither method is capable of completely overcoming the undesirable effects of these imperfections in the VAT system itself. In this case, the choice between them comes down to a comparison of costs and benefits in each.

With the credit method, the important negative implication is that exempting any firm (or merchant) situated anywhere before the final stage along the production-distribution chain breaks the credit chain and results in cascading, which reduces one of the fundamental benefits of having a VAT in the first place. With the subtraction method, no such cascading can result. It is, however, incapable of handling multiple rates. The preferred method therefore depends on the nature and severity of the imperfections of the VAT system. The general use of multiple rates is probably the most important reason for the prevalence of the credit method in the VAT systems around the world (Zee, 1995: 96).[11]

[10] A third method, known as the *addition method*, defines value added on the basis of the sum of factor payments, including profits. This method is rarely used.

[11] This limitation of the subtraction method could be removed by ensuring that the adoption of a VAT would only entail a single-rate, such as in Chile, Denmark, Ecuador, Indonesia, Japan, Madagascar, New Zealand and Pakistan (see Table 3.1).

3 Structural issues of VAT

Before introducing a VAT, four major structural issues should be addressed (Cnossen, 1992:229):

1. *The rate structure:* if a uniform rate is not acceptable because of distributional reasons, how should rate differentiation be effected?
2. *The base:* should the VAT extend through the retail stage, and how should small traders, farmers, and public sector bodies be treated?
3. *Treatment of services*: which services should be exempted?
4. *Legal and administrative features:* how to audit and punish defectors?

3.1 The rate structure

From a theoretical point of view there is no presumption that a single VAT rate will minimize economic distortions.[12] Multiple rates may, however, offer a greater opportunity to fit the VAT to various social and political ends (Gillis, 1990: 12). But having several rates adds (often significantly) to administrative and compliance costs, and may also create additional problems with similar goods being taxed at different rates (OECD, 1995: 15). Most countries with VAT therefore try to keep the number of tax rates to a minimum (see Table 3.1). Countries which have most recently introduced VAT, for instance Japan and New Zealand, have chosen one or at most two VAT rates.

In many countries the VAT applies either a zero rate or reduced rates to necessities, a standard rate to the majority of sectors, and a higher rate to luxury items and goods whose consumption the government wants to discourage (Mitra, 1992: 205). Recently, the possibility of VAT differentiation for environmental purposes has been raised (OECD, 1995: 20). The intention is to influence consumer demand for goods which represents negative or positive environmental effects in production, by using high and low VAT rates, respectively. Lower VAT rates on labour intensive services have also been suggested as a means to promote employment. Under the credit method this differentiation of rates by commodity can be achieved only at the retail level. It is the final sale to the consumer that must be given the lower or higher rate. If commodity-differing rates are imposed only at earlier stages, the credit mechanism by the uniform retail rate will wipe out the effects of the differentiation. In contrast, under the subtraction method commodity differentiation can be made effective at any stage without being cancelled at a later stage (Shoup, 1990: 12). Administrative feasibility is, however, often the principal obstacle to using different rates for policy purposes.

[12] According to the Ramsey pricing rule, the optimal tax structure which minimizes distortions is one where tax rates on goods are inversely related to the elasticity of demand for that good (see Atkinson and Stiglitz, 1980).

The distinction between *exemption* and *zero-rating* requires a brief explanation. Exempted sectors, because they are not part of a VAT, do not pay taxes on their output. The exemption releases one from the responsibility for collecting the VAT or filing any paperwork on sales and purchases. By the same token, one cannot claim credit for taxes paid on one's inputs. Hence exempted sectors are taxed on their inputs rather than on their outputs, whereas sectors under the VAT are taxed on their outputs rather than their inputs. Zero-rated sectors, by contrast, are exempted from taxation on both their inputs and their outputs. Zero-rating therefore offers a precise way of according relief from taxation.

Experience suggests that a VAT imposed at low rates may not be worth the administrative and compliance costs involved in the switch to the VAT. The start-up costs may be quite high in the first two or three years of application. In particular, the additional investment in tax administration that would be required before and during the first years of operation of the tax may be high. No rule of thumb exists, but Gillis *et al.* (1990: 221) argue that it is doubtful that an initial base rate below 7 percent would be worthwhile for developing countries planning to introduce comprehensive VATs.

Table 3.1 shows the main rates of VAT and additional rates applying to a subset of goods in some selected countries. The rates shown are those that apply to domestic sales; virtually all of the countries zero-rate exports. Kenya has the largest number of different rates – six; followed by Belgium and Morocco with five rates (including zero rating). Two or three rates are more common. Of the countries listed in the table several have additional taxes on particular commodities. These are separate from the VAT and are therefore not subject to refund. In the European Community, for instance, these additional taxes are excise taxes on tobacco, alcohol, gasoline, and diesel oil.

Table 3.1: VAT rates in selected countries

Country	Standard rate	Other rates
Belgium (1995)	20.5	0/1/6/12
Chile (1991)	18	None
Côte d'Ivoire (1991)	25	11.11/35.13
Denmark (1995)	25	None
Ecuador (1991)	6	None
France (1995)	18.6	2.1/5.5
Germany (1995)	15	7
Haiti (1991)	10	None
Indonesia (1991)	10	None
Italy (1995)	19	4/9/13
Japan (1995)	5	None
Kenya (1991)	17	20/40/50/270
Madagascar (1991)	15	None
Malawi (1991)	35	10/55/85
Mali (1991)	17	10
Mexico (1995)	10	0/6
Morocco (1991)	19	7/12/14/30
Netherlands (1995)	17.5	6
New Zealand (1995)	12.5	None
Norway (1995)	22	0
Pakistan (1991)	12.5	None
Senegal (1991)	20	7/34/50
South Korea (1991)	10	2/3.5
Sweden (1995)	25	12/21
Taiwan (1991)	5	15/25
Tanzania (proposal)	*20-30*	0/<10/10
Tunisia (1991)	17	6/29
Turkey (1995)	15	1/8/23
United Kingdom (1995)	17.5	0/8

Sources: Tait (1988); URT (1991a); Mitra (1992); and OECD (1995)

3.2 The base

Most countries with value-added taxes treat small traders differently — either excluding them from the scope of the tax or subjecting them to some kind of "simplified" system. Generally, there are two reasons given for providing special treatment for small firms:

- It may cost more to administer the taxing of small firms than the revenue produced.
- Tax evasion is most prevalent in this sector.

The relatively high compliance costs of VAT to small businesses argue in favour for special treatment. During the transition to a market economy, the number of small businesses in a formerly planned economy, in general, increase dramatically.[13] Initially, artisans and the small business sector, still in its infancy, can hardly be expected to keep adequate records of their transactions for VAT purposes. Small traders and artisans face relatively higher costs complying with the obligations imposed on them under VAT than do other taxpayers. At the same time, the tax administration will be fully occupied with collecting the new tax from large and medium-sized businesses, which have to introduce new accounting systems and are generally not used to complying voluntarily with taxes such as the VAT. The tax administration would therefore incur relatively higher costs in enforcing the VAT on the small business sector.

Most OECD countries with a VAT exclude small-scale traders and producers with an annual turnover below a specified amount, referred to as the registration threshold, from the obligation to register, furnish returns and pay tax, or keep prescribed records (OECD, 1995). Of course, exempting small firms does not mean that they do not bear VAT. Since the VAT is included in the cost of the goods and services it will presumably be passed forward to purchasers. It means that the value-added of such firms is not taxed.

As small businesses prosper the tax authority would presumably be in a better position to deal with them. Simplified schemes for specified small businesses, which would provide for the presumptive computation of the tax liability, may then be introduced. Such taxpayers may be obliged to furnish returns less often than regular taxpayers, to maintain simplified records, and to keep their accounts on a payments, rather than an accrual basis. Although it would not be advisable to spend excessive administrative resources on presumptive assessment schemes, some arrangement may be necessary, particularly if small firms would not be subject to the income tax.[14]

[13] This is also the case in Tanzania (URT, 1991b; and Bagachwa and Naho, 1995).

[14] Fjeldstad (1995b: 31) discusses this in relation to Tanzania.

Options available to policymakers for dealing with small business firms include exempting them from or establishing special tax regimes for them (OECD, 1995). Due (1990:68) notes that while exemption is the administratively expedient option, it may not be in the interest of the enterprises. By breaking the chain of tax credits available through the VAT exemption one may overtax firms which cannot credit the cost against their taxes. This fact reduces the gain from exempting small firms, and may provide an incentive for small firms to register for the tax.

The VAT treatment of farmers and other primary producers engaged in agriculture, animal husbandry, horticulture, forestry, fishing, etc., requires special attention in developing countries because of their importance to the economy and the essential nature of their products. If taxed, farmers would have to comply with the usual VAT obligations. If exempted, however, they would not incur compliance costs, but they would still have to pay the element of VAT on their inputs of feed, seed, fertilizer, equipment, and machinery for which a deduction cannot be provided. Because farmers are situated at the beginning of the production-distribution process, this element of tax would cascade throughout the process.

In the OECD countries, farmers are either taxed or exempted (Due, 1990; Cnossen, 1992). New Zealand, Sweden, and the United Kingdom treat farmers in the same manner as any other producers of taxable products; that is, they have to comply with the same requirements for furnishing returns and making payments. Other OECD countries do not require farmers to register and compensate them for the tax borne on their purchases of VAT-liable inputs. Inclusion of small farmers in the VAT system in developing countries would most likely pose serious problems for taxpayers compliance, due to low levels of literacy, accounting skills etc. Small farmers may also withdraw from the market and into subsistence farming when taxed or controlled by the state in other ways.[15] But probably more serious is the severe limitations on administrative resources, and lack of legal and economic sophistication, which at present makes it unrealistic to include small farmers in the VAT net. Due (1990: 68) suggests that one alternative may be to exempt small farmers from the registration requirement while zero-rating major farm-inputs, such as seed, fertilizer, pesticides, livestock, etc., and place a VAT on minor farm inputs.

3.3 Treatment of services

Service sectors constitute an important and increasing share of economic activity in all countries, ranging from about one-third of GDP in low income countries to two-thirds or more in high income industrial countries. On this background, inclusion of services within the base of a comprehensive VAT is advisable to

[15] This problem, related to the taxation of peasants in Tanzania, was first addressed by Hyden (1980).

increase revenue or to allow lower rates of tax on commodities (see Table 3.2). Both consumer services, e.g., restaurants, hotels and theatres, and business services (excluding financial services) can be included in the VAT base.

Some concessions must, however, be made for social policy considerations or on administrative grounds. It would, for instance, be difficult to defend and, in the absence of a charge, to administer the taxation of health, education, social and religious services. These public services are exempted in the OECD countries. A second group of activities often exempted includes (i) financial services, e.g., dealings in money, shares, bonds, lending money, operating bank accounts and advancing credit, (ii) insurance and (iii) gambling. These are usually exempted because of the difficulty of isolating and measuring the service element (Gillis, 1990). Exemption rather than zero-rating are chosen, principally for revenue reasons. Zero-rating would ensure equal taxation of closely-competing businesses in a way that exemption does not. Exemption, however, means that some tax is embodied in the price of the services sold to businesses (see section 3.1).

Housing services are also often excluded from the VAT base. These services could, however, be taxed by using separate levies outside the structure of the VAT (Conrad, 1990). Many countries do impose VAT on the sales of newly constructed buildings. This implies that owners of existing residential structures get all the benefit of any increase in the value of the building, following the imposition of VAT (OECD, 1995).

Table 3.2: VAT revenue and base in selected countries (1988)

Country	VAT revenue as % of GDP	VAT base
Belgium	7.2	G + S
Chile	8.8	G + S
Côte d'Ivoire	NA	G + ST
Denmark	9.5	G + S
Ecuador	2.5	G + ST
France	11.9	G + S
Germany	3.8	G + S
Haiti	1.8	G + S+ CG
Indonesia	4.5	G + ST
Italy	5.8	G + S
Madagascar	1.5	G + S
Mauritius	2.1	G
Mexico	3.4	G + S
Morocco	NA	G + S
Netherlands	8.0	G + S
New Zealand	6.7	G + S
Niger	NA	G + S
Norway	9.4	G + ST
South Korea	3.3	G + S
Sweden	7.5	G + S
Taiwan	2.6	G + S
Togo	NA	G + S
Tunisia	2.8	G + S
Turkey	1.7	G + S
United Kingdom	6.0	G + S

Source: Bogetic and Hassan (1993)

Codes: G = consumer goods only; G + S = consumer goods and services;
G + S + CG = consumer goods, services and capital goods;
G + ST = consumer goods and selected services.

3.4 Legal and administrative features

Although a VAT may not be as complicated as some observers seem to believe, the unfamiliarity with an accounts-based levy and the need for intensive taxpayer education most likely require an extension of the usual lead-in time in low income developing countries, including Tanzania. Experience suggests that it requires 18 to 24 months to make a VAT fully operational (Cnossen, 1992: 242).

The preparation and introduction of a VAT involves, in general, five major tasks (which are partially overlapping):

- Resolve major structural policy issues and secure parliamentary approval of the VAT law.
- Design administrative systems and procedures (including computers).
- Prepare staff instructions (manuals).
- Train staff.
- Provide taxpayer advisory services.

Experience indicates that it is useful to draw up a detailed timetable for the various steps to be taken from the day of the VAT's inception to the first day of implementation.[16] Sound preparatory work minimizes the number of flaws that show up later — when they are much more difficult and costly to correct.

The tax credit type of VAT (see section 2.4) does have three anti-evasion features not present in a retail sales tax. First, its self-policing attributes; second, its possibilities of cross-checking of invoices; and third, its tendency to collect a major portion of revenues before the retail stage. The administrative benefit of the self-policing feature arises from the fact that underpayment of the VAT by a firm selling to another firm increases the VAT liability of the buyer. This advantage is probably only significant as long as evasion at the point of final sale is not endemic (see section 4.2). The advantages offered by cross-checks under the VAT also depend much on the firms' perception of the tax administration's capacity (and intention) to perform cross-checking operations (Sandford and Godwin, 1990).

A successful VAT depends on effective auditing, which should be selective and comprehensive. Proper guidelines for auditing are essential, e.g., an audit selection programme, based on, among other criteria, gross profit margins and type of economic activity. Finally, swift and automatic (administrative) penalties are essential, differentiated by type of transgression: failure to register, to file a return, or to pay the tax.

[16] For example, the Tanzanian Tax Commission (URT, 1991a) presents an implementation programme in its report (see section 5.3).

Penalties for late payment of VAT in the OECD countries, for instance, consist of payments either of a single fine, invariably expressed as percentage of the overdue tax, or a cumulative monthly fine based on the total amount outstanding, or both. These penalties vary significantly from country to country (OECD, 1995: 49). In general, fixed fee penalties provide a strong incentive to pay promptly, but for an extended period of non-payment, the cumulative nature of the monthly penalties quickly amounts to a large sum.

In many countries the same tax inspectors control VAT, income tax and the main capital taxes paid by a taxpayer. Separate tax returns may be furnished by the taxpayer, but any control or audit covers all of the taxes for which the department is responsible. The different tax returns can be systematically checked against one another for consistency and credibility. In other countries taxes are administered by separate tax departments (which is the case in Tanzania, at present).[17] Usually access to the tax returns handled by another department are strictly controlled. Tax controls and audits generally focus on the tax for which that particular department is responsible. In this case, procedures enabling the flow of information from one department to another may be developed. Joint audits may involve groups of tax inspectors who specialize in different taxes.

4 Complications in applying a VAT

Despite the growing popularity of value-added taxes in developing countries it is important not to overemphasize the role of this tax. The recent trend reflects to some degree a change more in form than in substance, with most revenue most likely continuing to come from taxes on international transactions (particularly on consumer goods imports), and the typical excise and sales tax base of the so-called "demerit goods", i.e., beer, tobacco, spirits, etc. (see, e.g., Fjeldstad, 1995b).

Critics of the VAT usually focus on (i) income distribution, (ii) administrative complexity and tax collection costs, and (iii) inflationary effects:[18]

4.1 Income distribution

The most common criticism is that the burden of VAT is distributed regressively with respect to income. Since consumption as a share of income falls as income rises, a VAT levied at a uniform rate falls more heavily on the poor than on the rich (see, e.g., McLure, 1990). This is because it is nearly impossible to

[17] Recently, the Tanzanian Government has established a new tax authority; *Tanzania Revenue Authority* (the Act was signed on August 8 1995). The two existing tax departments, the Department of Income Tax and the Customs and Sales Tax Department, will, after a transitionary period, be shut down, and their responsibilities transferred to the new authority.

[18] See, e.g., Cnossen (1992).

distinguish, for instance, expensive higher-quality food products bought by the rich from less expensive ordinary food products bought by the poor. If such a distinction is not feasible, lower rates become less effective in reducing the regressivity of the VAT.[19]

If no tax relief is granted to the poor under a VAT, the burden on them might be offset by using the extra VAT revenue that derives from taxing necessities consumed by the poor to supply them with additional transfer payments in cash or free government services. Instead of distorting the tax system through diversified tax rates, cash may be a more efficient way of reaching the poor (see, e.g., Metcalf, 1995: 134). This solution, however, underestimates the greater administrative difficulties in developing countries, compared with high income-countries, of using transfer payments to alleviate poverty.

For distributional reasons many developed countries hesitate to apply a single value added tax rate across the board (Sandford et al., 1990: 214). A developing country that lacks a sophisticated social security system to compensate the poor for the higher prices of necessities due to VAT, has much more reason to be cautious in this respect. Attention should therefore be devoted to techniques of removing from the tax base certain consumption goods, notably foodstuffs, that play a larger role in the budgets of the poor than in those of the richer income groups. This may also be a more cost efficient alternative than cash transfers. In a developing country the question of introducing more than one rate of VAT should be determined by the extent of commitment to certain social and economic policies. The major constraint, however, is probably to fit the tax to the limited administrative capacity of the country in question.

4.2 Administrative complexity and tax collection costs

Strong arguments have been advanced against the use of multiple rates under a VAT. To begin with, rate graduation is a very blunt and expensive instrument for mitigating regressivity. There seems to be general recognition that departures from uniform rates of VAT do give rise to complications and costs for the tax administration and taxpayers alike (Gillis et al., 1990:224). Widespread illiteracy and innumeracy characterizing many developing countries make record-keeping burdensome, particulary for small businesses and farmers. Payments of refunds may therefore create particular difficulties. Further, the capacity of a VAT to resist tax evasion in part relies on sophisticated cross-checking, on computerization, and

[19] Recent tax incidence research argues that a broad-based consumption tax (e.g., a VAT) is proportional over the consumer's lifetime (see, e.g., Metcalf, 1994). In the absence of legacies, lifetime income will equal the present discounted stream of consumption. From this view, a proportional broad-based consumption tax would exact the same fraction of lifetime income from everyone, and the tax appears proportional rather than regressive.

on a staff of well-trained and motivated staff. These resources are, in general, inadequate in developing countries, and evasion is often more prevalent (Fjeldstad, 1995a and 1995b). VAT may also provide an opportunity for fraud through fictive claims for excessive credits and rebates, particularly through the use of counterfeit invoices. This opportunity is not available in other forms of sales tax (Sandford and Godwin, 1990; and Kay and Davis, 1990). The VAT introduced in Guatemala in 1983, for example, failed to match the changed tax structure with an appropriately changed tax administration, and had disastrous effects on revenue collection (Bird, 1992: 121).

The costs of administrating a VAT are inevitably increased by a differentiated rate structure, because it may lead to problems of delineating products and interpreting the rules regarding which rate should be applied (see section 3.1). Experience in both developing and developed countries indicates that a VAT imposed at low rates may not be worth the administrative and compliance costs involved in the switch to the VAT. According to Sandford and Godwin (1990: 214), "there is much in the conventional wisdom that, on balance, a retail sales tax is preferable if the rate is low but that the value added tax has the advantage if the rate is to be high".

Based on a sample survey in the United Kingdom, Sandford and Godwin (1990) found that the compliance costs of the taxpayer, expressed as a percentage of the tax itself, were considerably higher than the administrative costs of the government in collecting the tax. Differentiated rates involve a significant increase in compliance costs, particularly of small firms. Usually, it is not possible for small firms to keep separate accounts for the sales of differentially taxed products. The tax liability must then be determined by applying presumptive methods, an approach that increases the difficulty of monitoring the taxpayer's compliance. There is also evidence that the increase in compliance costs attributable to differentiated rates is distributed regressively with respect to income (Cnossen, 1992). Smaller firms with lower incomes bear proportionally more of the burden than do larger firms.

4.3 Inflationary effects

An often-voiced concern in countries without a VAT is that the introduction of the tax would set in motion a spiral in which the tax, prices and wages would feed on each other, that is, a VAT would be inflationary. This view often confuses a one-time price increase with a continual increase in prices. In an extensive study about the potential impact on prices of introducing a VAT or changing its rate structure, Tait (1990) found that in 22 out of 35 cases evaluated, the introduction of the VAT had little or no effect on the consumer price index. In 8 cases the introduction of a VAT was associated with a once-and-for-all upward shift in the consumer price index. In only one of these cases could this shift be said to

contribute to an acceleration in the rate of increase of the consumer price index.[20]

Whether prices rise or not depends on whether the tax is passed forward or passed back in the form of lower factor payments. What happens will depend on the response of the Central Bank. An accommodating monetary policy would allow consumer prices to increase by the same of the tax while a tight policy would force factor payments to fall (Metcalf, 1995: 130). Price controls have also been used effectively to dampen the potential price-wage acceleration of inflation after the VAT introduction in, for instance, Austria, France, South Korea, the Netherlands and Norway (Tait, 1990).

5 Value-added tax in Tanzania

The replacement of the present sales tax by a value-added tax is the Tanzanian Tax Commission's central recommendation in the area of indirect taxation. It seems clear that the Commission envisages the VAT, and its potential future extensions to a wider tax base, as a major component of Tanzania's future revenue system (see section 1). The Commission states that it "considers that the smooth introduction of a VAT is so important that it has not recommended any major changes in the current structure and rates of Sales Tax which would merely disrupt the vital work for the transition and operate for only a limited period" (URT, 1991a: executive summary para. 25). Initially the coverage of VAT was recommended to be as for sales tax as currently applied, namely at the level of manufacturers and at the importer level. The proposed VAT should also be applied to services which are currently sales taxable and a few other services. Over time, VAT should be extended to the wholesale and, subsequently, to the retail level. In this section I describe and discuss some important features and principles of the proposed VAT system.

5.1 Principles of a VAT in Tanzania

The present Tanzanian sales tax is applied on the *suspension* principle, whereby producers of taxable goods are permitted to buy taxable inputs free from tax. The sales tax is imposed when the sale of goods by manufacturers takes place or on importation of similar goods. Manufacturing in this context is defined as "a process which changes substance, character (for example through assembly), or appearance (e.g. dyeing) of the goods" (URT, 1991a: para. 12.1). The suspension system operates through the use of Registered Dealer Certificates, whereby registered dealers can buy taxable raw materials and other taxable inputs free of tax. Exporters and duty free shops are entitled to similar treatment under Export

[20] See also Zee (1995: 90) for a discussion of price effects of a VAT.

Certificates which enable them to buy goods for exports and for duty free sales free of tax.

The potential benefits of replacing the existing sales tax by a VAT were expected to be fivefold:

(i) The flexibility of setting the VAT-rates was expected to give scope for generating increased revenue (URT, 1991a: para. 12.8). The increased revenue productivity required the VAT base to be broad, covering as many goods and services as possible.
(ii) The invoice-credit method of VAT (see section 2.4) was expected to minimize unintended distortions by avoiding the tax cascading of the existing sales tax system (URT, 1991a: para. 12.9).
(iii) By applying the destination principle (see section 2.4) the VAT should ensure that commodities were taxed in the country where they were consumed (not in the country where they were produced) as required under the provisions of the General Agreement on Tariffs and Trade (GATT). This was assumed to be achieved by (a) levying the same tax on imported goods and on goods domestically produced; and (b) freeing exports from tax (URT, 1991a: para. 12.10).
(iv) Simplicity was expected to be to achieved by limiting the number of VAT rates as well as the number of exemptions (URT, 1991a: para. 12.11).
(v) It was anticipated that once the traders became used to filling in the VAT-forms, evasion would decline due to the self-policing nature of VAT (URT, 1991a: para. 12.12; and 12.13). In this respect, it was also expected that VAT would encourage traders and manufacturers to keep proper records, and encourage purchasing and recording inputs on which tax had been paid (URT, 1991a: para. 12.41). As the practice of keeping proper records spread, one expected that the tax base for VAT would grow to a wider coverage than sales tax and revenue would increase (URT, 1991a: para. 12.23; 12.24; 12.41; 12.42; and 23.8).

Further, VAT was favoured because it was assumed that it had a relatively high tax elasticity and buoyancy compared to sales tax (see Osoro, 1992). The Commission is, however, rather vague as to the revenue implications of its VAT proposal (URT, 1991a: para. 24.20), apparently because of uncertainty both as to the final rate structure and the extent to which exemptions would be eliminated.

5.2 The VAT base and rates

The Tax Commission argues convincingly that the introduction of a full-fledged VAT in Tanzania would be difficult (URT, 1991a: para. 12.15). This process is inhibited by weaknesses in tax administration, the limited scope of the present tax system (see Fjeldstad, 1995b), and the relatively low level of economic

sophistication, particularly in the business sector. For instance, the retail sector in Tanzania is comprised mostly of small outlets without adequate records; a situation which would precipitate problems of compliance and control. Similarly, limiting the VAT's application to cover only wholesales would also be problematic since wholesale activity is not a clearly defined category. Wholesale is often conducted by firms which are also manufacturers, and may also include retail businesses (URT, 1991a: para. 12.18).

On this background, the Commission recommended that VAT should initially be confined to the import and manufacturing levels. However, over time, the Commission argued, that the VAT should be extended to the wholesale, and subsequently, to the retail level (URT, 1991a: para. 12.19).

The VAT base will, according to the Tax Commission, be significantly broadened vis-a-vis the present sales tax system (URT, 1991a: para. 12.23). First, the domestic manufacturers who are currently excluded from sales tax, and, hence, unregistered as sales taxpayers will be registered as taxpayers under a VAT system. Second, a number of items not liable to sales tax will be subjected to VAT. Third, the number of goods excluded from tax would be limited. For example, the Commission recommended that the existing "discretionary" exemptions from sales and excise taxes – like those on customs duties – shall be abolished (URT, 1991a: para. 12.24). At the same time, the Commission recommended many of the existing excise taxes, notably on textiles, to be eliminated (URT, 1991:para. 13.15). This has now been done for locally produced textiles – with the remaining excises being levied at rates ranging from 10 to 85 percent (Fjeldstad, 1995b). Fourth, VAT will be extended to include services such as electricity, telephone, private mail courier services, and designated hotels and restaurants. For social and administrative reasons, certain services were recommended to be excluded from VAT, e.g., safari tours, domestic and international air transport, road and rail transport, professional services (other than health services), hair dressing, motor vehicle maintenance and repair, etc. (URT, 1991a: para 19.24a). The Commission further recommended that there shall be no exemption for small firms (URT, 1991a: para. 12.26).

A VAT with four rates was recommended (URT, 1991a: para. 12.34):[21]

- Zero rate for basic goods such as farm inputs (e.g., fertilizers, seeds, agricultural machinery and tools), unprocessed food, live animals, nursery stocks, industrial machinery and exported goods (URT, 1991a: para. 12.24b).

[21] The Commission states that it "recommend two positive rates in addition to the zero rate" (URT, 1991a: para. 12.34). However, since the Commission argues in favour of a VAT rate applied to services *not above 10 percent*, I consider this as a rate different from the proposed 10 percent rate on utilities and essential goods.

- A low rate, not above 10 percent, for services such as international telephone calls, electricity and transport (URT, 1991a: para. 12.36).
- A rate of 10 percent on utilities and some essential items, e.g., baby foods and dietetic products (URT, 1991a: para. 12.35).
- A standard rate between 20 and 30 percent.

5.3 VAT administration

To administer the VAT the Tax Commission recommended creating a new Sales Tax Department (URT, 1991a: para. 21.6). Although it is important for the successful operation of the VAT that the organization, and probably some of the personnel, not simply replicate the existing sales tax part of the Customs and Sales Tax Department (CSTD), one should be cautious in establishing new administrative units. Tax reforms may, however, provide an opportunity to introduce improvements to strengthening tax enforcement and improving the existing tax administration.[22] Most of what the Tax Commission's Report has to say in this respect is very reasonable. For example:

- More use can be made of information already available to the tax departments (URT, 1991a: para. 23.6).
- There should be more exchanges of information between these departments and other government agencies (URT, 1991a: para. 23.6).
- There should be more careful supervision of third-party withholders (URT, 1991a: para. 6.55).
- There should be established a system of unique taxpayer numbers (URT, 1991a: para. 6.100).
- There should be established a meaningful system of field audits (URT, 1991a: para. 11.47).

Although several potential problems were recognised by the Tax Commission, these were not considered as critical impediments for introducing a value-added tax. However, the following factors (also mentioned by the Commission) need serious consideration before introducing the VAT. First, even a simple VAT, where only manufacturers are the liable tax units, will be a more complex version of the sales tax but applying also to inputs. Second, a VAT will probably impose much higher collection and compliance costs than the existing system, largely because of the detailed recording and monitoring required. Third, and related to the first two, the present Tanzanian tax administration is probably not able to introduce a VAT system smoothly and efficiently. As the existing system of keeping records is limited any VAT system will be difficult and costly, in both time and training, to introduce, Finally, the complexity of records required can

[22] The Government seems to have seized this opportunity by establishing *Tanzania Revenue Authority* (see note 17).

encourage evasion. Fraud may also be encouraged through fictive claims for excessive credits and rebates (see section 4.2). On this background, further consideration is needed on a number of aspects of the VAT-excise package, including:

- A gradual incorporation of the small business sector into the VAT net, may take several years. In the current situation, it is *not* advisable, contrary to the Tax Commission's recommendation, to include this sector in a VAT system (see section 3.2).
- Close attention should be paid to the transitional problems that have bedeviled VAT adoption in other developing countries (see Gillis et al., 1990). It may also be wise to investigate carefully the experiences of Malawi and Kenya, which adopted VAT in 1989 and 1990, respectively.
- Simplicity should be emphasized, in particular by limiting the number of VAT rates to a maximum of two (see section 5.2).
- Care should be taken to avoid increasing regressivity of the tax system (e.g., by exempting not only unprocessed food but also a limited number of other basic food items).
- If VAT is implemented, one should consider to include excise duties in the VAT base. Further, excise rates should be adjusted to maintain the desired effective tax rate. While it may be desirable to retain specific rates for certain high-rate excises, one should consider the possibility of making explicit provision for periodic adjustments to retain the real value of such taxes.

Experience throughout the world suggests that to design and implement a value-added-tax, starting from Tanzania's present situation, is likely to take about two years (Cnossen, 1992: 242). The Government of Tanzania announced in its 1992 Budget its intention to replace the existing sales tax with a VAT in January 1994.[23] To this date, however, little progress has been made in this area. Several years will therefore pass before much revenue can be counted on from this source.

6 Conclusion: Should Tanzania introduce VAT?

There is no *a priori* reason for proclaiming that the value-added tax is better or worse than a retail sales tax. Conventional wisdom indicates that a VAT is preferable if the rate is high but that the sales tax is preferable if the rate is to be low (Sandford and Godwin, 1990:214). The unique features of the VAT, i.e., the multistage collection and the rebate system, may, despite increasing administrative and compliance costs compared to a sales tax, provide a more accurate and reliable mechanism for excluding tax from business costs and export prices. A

[23] The Tax Commission recommended the VAT to be introduced at the beginning of fiscal year 1993/94, i.e., July 1993 (URT, 1991a: para. 12.44). In its report, the Commission also presents a VAT implementation programme, covering twenty four months.

VAT structure with minimum exemptions and one or two rates will minimize the administrative and compliance costs and maximize the advantages claimed for value added taxation. However, multiple VAT rates are often chosen for distributional purposes in developed countries. A developing country, that lacks a sophisticated social security system to compensate the poor for the higher prices of necessities due to the VAT, has reason to be cautious in this respect.

The disadvantages of the VAT structure seem to be accentuated in low income countries (see section 4), and its potential advantages are less likely to be realized (see section 2). For instance, many of the administrative and compliance problems of VAT observed in OECD countries are more significant in developing countries, where the small business and farming sectors constitute a larger part of the economy. Sandford and Godwin (1990) report that small businesses in the United Kingdom have difficulties with record-keeping for VAT. In countries where literacy and numeracy are much less widespread, record-keeping is even more burdensome. Payments of refunds create particular difficulties in many countries. Further, the capacity of VAT to resist evasion rests in part on relatively sophisticated cross-checking and on a corps of well-trained and adequately paid tax officers. These resources are inadequate (or absent) in many developing countries, and evasion is consequently more prevalent. VAT also provides opportunities for fraud not available in other forms of sales tax; i.e. fictive claims for excessive credits and rebates, particularly through use of counterfeit invoices. In addition, the more exemptions there are, the less complete and precise the exclusion of tax from export prices.

Should Tanzania introduce a value-added tax? The administrative limitations are at present most evident in respect of VAT in Tanzania. Before implementing a VAT, both tax collectors and payers require training, preparation and manuals. Its introduction, given the situation as of late 1995, would probably be disastrous. There is a widespread unpreparedness, no or inadequate records, and the increased compliance costs incurred by taxpayers will most likely encourage evasion (see section 4.2 and 5.3). The merit of the existing sales tax lies in its simplicity, at least relative to VAT.

This does not mean that the VAT does not have important merits for a low income country such as Tanzania. However, expectations must be set lower, and the tax must be trimmed to administrative capacity. It is particularly necessary to exclude from the standard VAT structure the myriad of small business-people and farmers who would find it impossible to keep adequate accounts. This measure will probably involve little revenue loss but considerable savings in costs of administration and compliance. Experience also suggests that a VAT is introduced most easily when it replaces a cascade tax or some other general sales tax that has already accustomed small firms of record-keeping. The extension of the existing sales tax to this sector may therefore be a better alternative in Tanzania than introducing a value-added tax.

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