

The Multiple Dividends of Abolishing Statutory Tax Exemptions

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Abstract: This paper shows that the need to increase tax revenue in Tanzania is obvious and that this can be done through a base-broadening, marginal rate-reduction and simplification of tax reform. It argues that minimising statutory exemptions shall, not only broaden the tax base, but also simplify the tax system, improve compliance and enhance transparency and good governance. Marginal rate-reduction in personal income tax as well as in the value added tax could be expected also to impact favorably on voluntary compliance and economic efficiency hence resulting into an even broader tax base in the future. The paper also builds a case for a more effective enforcement of the tax regime on employment income and a commitment to a consistent tax reform agenda so as to minimise the uncertainties in the existing tax policy stance.

INTRODUCTION

For a country like Tanzania where the tax revenue to GDP ratio is so low and opportunities for reducing public expenditure do not exist,² one could rightly expect the Government to regard tax policy as primarily serving its revenue goals. This being the case, any significant tax reform in the Tanzanian context must, in the final analysis, be revenue-enhancing. Nevertheless, taxation is not without costs. In addition to the obvious direct costs of tax collection, taxation imposes costs also in terms of economic inefficiencies as well as social inequities (Shome, 1995). A need therefore exists to impose taxes in a manner that minimises the costs of taxation, i.e. optimal taxation.

On the other hand, tax policy is invariably used for non-revenue goals notably resource allocation, redistribution and investment promotion, just to mention a few (For example Faria, 1995). It has generally been acknowledged in the literature that the effectiveness of different tax instruments in attaining different tax policy goals differs. For example, fine-tuning the direct tax regime is likely to yield desirable redistribution results than fine-tuning the indirect tax regime, more so in

developed than in developing countries. Also, a properly designed VAT raises more revenue with lower administrative and economic costs than other broad-based consumption taxes (Cnossen, 1998). It is also obvious that the more goals that tax policy tries to attain the more complex the tax regime becomes. The latter complicates tax administration thus resulting into, not only increased opportunity for tax evasion, but also higher administrative costs and worse still, corruption.

In order to increase tax revenue in Tanzania, there are a number of options available to tax policy makers. The most obvious (which is frequently resorted to in Tanzania) is reviewing upwards the tax rate structure. Another option is broadening the tax base through various measures such as cutting down tax allowances, limiting deductions, tax credits and exemptions. In this paper, we argue for a base-broadening, marginal rate-reduction and simplification of tax reform as has successfully been attempted in most developed countries (Willner and Granqvist, 2002). We also argue for the elimination of specified exemptions and as well as for more effective enforcement of existing provisions for the taxation of income from employment under the Income Tax Act, 1973. We also argue for the reduction in the marginal rates for personal income tax and value added tax (VAT) primarily in order to induce voluntary compliance.³ In conclusion we argue

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² According to World Bank (2000) Government revenue as a percentage of GDP amounted to an average of 25% for African countries whereas the average Government expenditure amounted to 30%. For Tanzania, the figures average about 11 and 18% respectively (Mugoya, 1998).

³ The reduction in marginal tax rates is said to increase both the demand for and supply of labor as well as reducing the deadweight loss of taxation. In this way, such a reform has favorable impact on economic activity that may offset

for the need to think out and adopt upfront a more certain and 'far-sighted' tax policy reform program in place of the current ambivalent tax policy stance.

TAX EXEMPTIONS

The tax law of Tanzania provides for exemptions from various taxes under specified instances. There are exemptions for each of the three major types of taxes, i.e. income tax, value added tax and customs duties. The appendix to this paper provides a list of the existing customs exemptions (allowing the levying of no import or suspended duty, or reduced rate of import or suspended duty). It is true that there is nothing the Government can do about tax exemptions emanating from international obligations (such as the Geneva Convention on Diplomatic and Consular Immunity). However, there is much within the powers of the Government when it comes to conclusion of specific agreements with a given donor or group of donors. In the same way that the Government has stood firm to assert the sovereignty of our nation in other matters (e.g. radar acquisition), it should do the same to convince donors, for example, that salaries payable to employees in their donor-funded projects should be taxable in accordance with the existing tax regime. It appears to us that official Government policy should now be to concede granting donor-driven exemptions only as the last resort, i.e. only when the aid will otherwise be withdrawn.

As for granting tax exemptions on grounds of domestic socio-economic policy, policy reform is long overdue. We wish to point out three major dangers of pursuing non-revenue, socio-economic policy goals through the fine-tuning of tax policy:

- i) Subjectivity in deciding which sub-sector/social group to treat preferentially hence inefficiency allocation of economic resources - possibly leading political corruption;

the loss of revenue due to the lower rates (See Willner & Granqvist, 2002).

- ii) Complications in tax administration, hence non-compliance - possibly leading to corruption among tax administrators; and
- iii) Narrow tax base hence higher tax leading to non-compliance, tax evasion and corruption.

As a step towards addressing the above-cited snags, it is recommended that all customs exemptions to private companies and individuals be abolished with immediate effect. It is important to note that this one bold step implies that more than 30 percent⁴ of customs exemptions will no longer be available equivalent to absolute savings in tax revenue amounting to over Tshs. 50 billion. To avoid the above dangers, it is further proposed that should the Government feel convinced that a particular sub-sector deserves public assistance, policy should basically undertake to offer direct subsidy rather than tax exemptions. In other words, it would be better for the Government to collect all tax revenues and then spend the revenue in such a way as to meet its domestic socio-economic policy objectives, including subsidising vulnerable social groups or priority economic sub-sectors. This would be a safeguard to the latter two dangers. Moreover, since granting an exemption is likely to leave policy makers with an illusion of a lesser fiscal impact than offering a direct subsidy, such a policy stance will also go a long way to address inefficiency in the allocation of public resources by deterring future inclinations to discriminate against social groups and/or economic sub-sectors. Moreover, it is obvious that, replacing tax exemptions with direct subsidy will serve better our treasured cause of transparency and good governance.

In specific terms we propose the elimination of the under-mentioned exemptions under the Income Tax Act, 1973 and the Value Added Tax Act, 1997. The arguments for elimination in each case is either that under the current socio-

⁴ According to TRA records, Customs exemptions to private companies and individual exceeded Tshs. 51 billion during fiscal 1998/99. The exemptions under this category were equivalent to about 35 percent of all exemptions granted by the Customs and Excise Department during that year.

economic environment there exists no rationale socially or economically, or the exemptions impose an unnecessarily too heavy a burden on tax administration leading to evasion and possibly corruption or that they deny suppliers from enjoying input tax credit, or the exemptions reinforce the old-fashioned mindset of exempting from taxation persons, institutions that as a nation we highly respect.

Under the Income Tax Act, 1973, the following paragraphs in the First Schedule should be repealed forthwith:

- Para 3 Income of the President from specified sources;
- Para 7 Income of any approved pension scheme;
- Para 8 Income of any approved pension fund;
- Para 9 Income of any approved provident fund
- Para 9A Half of gratuity or commuted pension payable to a resident.
- Para 10 Income from the investment of an annuity fund as defined under Section 20.
- Para 11 Pensions or gratuities in respect of wounds or disabilities suffered in war
- Para 12 Specified disturbance allowance to a person formerly working with the East African Community or any of its Governments
- Para 13 Attendance allowances to Members of the East African Legislature or Ministerial Members
- Para 14 Entertainment allowance paid to East African Ministers or Deputy Ministers
- Para 15 Any fixed allowance to Chairman of the East African Legislature and the Secretary General of the Community
- Para 16 Foreign allowances paid from public funds to any officer of the Government or the Community

On the same arguments, it is also proposed that under the Value Added Tax Act, 1997, the following paragraphs in the Second and Third Schedules to the Act be repealed forthwith.

Second Schedule

- Para 14 Tourist Services and Tourist Charter Services
- Para 15 Postal Supplies
- Para 16 Aircrafts maintenance
- Para 20 Provision or supply of local processed yarn
- Para 21 Supply of packing material to any registered milk processor

Third Schedule

- Para 5 Supply of specified goods to the Armed Forces
- Para 15 Importation by or supply to a public institution that receives Government subsidy, whose establishing statute provides for relief from taxation
- Para 17 Importation by or supply of capital goods to a registered educational establishment

Whereas the extent to which the above-specified paragraphs do actually achieve the objectives for which they were intended is contentious (see for example Krelove, 1995 and Mugoya, 1998), but there is no doubt that the existence of the exemptions impose huge demands on tax administration and offer increased opportunity for both evasion and corruption. Moreover, the existence of so many in-built exemptions reinforces the flawed (but now deeply-rooted) view that whoever does something important for the nation deserves recognition in the form of tax exemption. This being the case, doing away with these kinds of exemptions will be a step in the right direction in that it will send the right signals to taxpayers that in fact a 'patriot' is the one who pays his/her taxes not the other way round.

ENFORCING FULLY TAX ON EMPLOYMENT INCOME

Sub-paragraph (a) (ii) of sub-section (2) of section 3 of the Income Tax Act, 1973 read together with section 5 of the same legislation imposes tax on any income in respect of any employment or services rendered. The tax is unambiguously imposed on any form of

remuneration whether in cash or in kind, whether on or off payroll provided it can be shown that it is a gain from employment or services rendered.

Unfortunately, the practice has traditionally deviated from the legal position. According to our understanding, no taxpayer has ever been taxed on in kind employment benefits such as housing, car or furniture benefit, free telephone use or medical services, etc. Moreover, off-payroll cash payments have almost always escaped income taxation for unexplainable reasons. They include the notorious sitting allowances, entertainment allowances, prizes, bonuses, honoraria, etc. paid by different institutions, both private and public (it is said including even the Ministry of Finance and TRA itself!).

We propose that an effective date for this full enforcement be identified and be made public. Naturally, implementation of the legal provisions pertaining to taxation of employment income could turn out to be impracticable administratively, politically or otherwise since a good number of employees (including highly regarded public officials, tax administrators and ordinary citizens) would automatically become the culprits. It is for this reason that we propose a general tax amnesty for everybody. Tax affairs of individuals prior to the identified effective date should not be investigated. Instead, a public awareness campaign on the amnesty and the tax obligations would have to be waged for a period of about six months prior to such effective date. The same time should be used for preparations to enforce the Income Tax Act, 1973 as it relates to income from employment or services rendered. These include strengthening the withholding tax regime and possibly studying and putting in place suitable mechanisms to require all employees to file tax returns annually and also to provide TRA with the capacity to effectively and efficiently process the filed returns.

REDUCTION OF THE TAX BURDEN

The two measures proposed above (eliminating a number of exemptions and enforcing provisions

related to taxation of employment income) are clearly revenue enhancing. It is, in deed, reasonable to expect that the resultant revenue increase will be even much greater. The 'right signals' that the removal of exemptions shall send is likely to increase voluntary compliance among many well intentioned taxpayers as it will be clear to the public that paying taxes is one of the pre-requisites for anyone who considers himself/herself to be a good Tanzanian, whether that person is an ordinary citizen, a religious leader, an army general, an MP, a Cabinet Minister or even the Head of State himself (current and retired).

We propose that part of the resultant tax revenue increase be utilised to reduce the tax burden so as to instill even more a sense of voluntary compliance as follows:

Personal income taxation rate structure (Third Schedule to the Income Tax Act, 1973) be reviewed so as to reduce by 5 percent the marginal tax rates for each tax band. This will reduce the marginal tax rates from the current 17.5%, 20%, 25% and 30% to 12.5%, 15%, 20% and 25%.

It is also proposed that all taxpayers be required to file annual income tax returns (subject to a specified threshold). Consequently, the current withholding taxes on dividend, interest, rent, technical or other fees etc. should not be treated as final tax. In this way, the income tax regime would be truly 'global' and then only will the progressive rate structure make 'sense.'

The revenue impact of the reduction in the PAYE burden should be more than compensated by the effective inclusion of all remunerations (in-kind, off-payroll etc.) in the tax base. As for the Value Added Tax, it is proposed that the standard rate be reduced from 20 to 15%. Again, here the resultant increase in compliance level as well as the elimination of the exemptions listed above should more than compensate the expected loss of tax revenue.

Although the precise quantification of the implication of these proposals on the level of tax

revenues requires an in-depth study, it seems reasonable to assume that the overall revenue impact cannot be negative. A good number of different types of compensation for employment or services rendered which currently go tax free will be brought into the tax net. The good thing here is that all these payments are recorded. It is only the political will that is needed to effectively enforce the law.

TAX REFORM IN THE LONG-TERM

Tanzania's tax policy has so far been characterized by ambivalence and inconsistent reform measures. For example there have been four different regimes since 1990. Firstly there was the NIPPA selective tax holidays regime 1990-1997. Secondly, there was the TIC selective regime 1997-1999. Thirdly there is the 1999-2002 regime with all investors treated alike and 100% immediate deduction of non-building investment, interest non-deductible and five year limit on carrying forward of losses. Fourthly there is the 2002 onwards regime, also with all investors treated alike but, with the above three measures reversed. Since existing literature has long suggested significant welfare costs resulting from uncertain tax policy in terms of inefficiency [for example Skinner (1988) and Bizer and Judd (1989)] and since now we know that uncertain tax policy can 'affect people from different income levels differently, the need for the Government to agree and commit itself to a long-term (medium-term) tax reform program is obvious (see Chun, 2001).

The hitherto practice of setting tax policy each year without a blueprint of the tax regime that the country wants to put in place in the medium to the long-term makes Tanzania's tax policy highly uncertain. Of course, such a blueprint requires careful study and thorough involvement of all key stakeholders, including the public, political parties, civil society, local governments etc. Indeed, such a blueprint must at the minimum address the issue of developing a culture of paying taxes among Tanzanians, including enshrining this

duty in the Constitution in no uncertain terms. To start with, there is need for work in this direction to start this coming fiscal year, possibly by setting up a team of experts to kick-start the process of developing a blueprint for the country's tax policy through relevant studies as well as consultations with a range of stakeholders.

CONCLUSION

In this paper we have attempted to build a strong case for the primacy of revenue concerns in tax policy formulation for Tanzania. Such a policy stance is supported not only by the current revenue yield inadequacy that characterizes the existing tax system but also by the argument that tax policy, especially in developing countries has neither been an effective nor an efficient means for achieving non-revenue objectives such as redistribution or efficient resource allocation. In addition, we have also spelt out how the pursuit of non-revenue goals through tax policy complicates tax administration, creates loopholes for tax evasion or avoidance and provides room for corruption. For the most part, scrapping the numerous statutory exemptions currently provided for in the tax legislation shall go a long way to rid Tanzania's tax policy of non-revenue goals. The goals that the exemptions are supposed to achieve can, after all be attained through the expenditure side of the budget in a process that promotes good governance by being more transparent. Coupled with the more effective taxation of fringe benefits as noted earlier in the paper, the scrapping of most of the existing tax exemptions can be expected to considerably increase Government revenue to GDP ratio. Reviewing the marginal rate structure for income and value added taxes are the other issues that deserve serious consideration. Existing literature suggests a positive revenue impact resulting from the reduction of marginal tax rates. This may be the case due to enhanced voluntary compliance as well as the expected favorable impact on economic activity that may offset the loss of revenue owing to the lower rates (Willner and Granqvist, 2002).

We have also advocated for a general tax amnesty as a politically workable strategy to start on a clean slate as a nation that cherishes the duty of paying taxes. It occurs to us that this is probably the only feasible approach bearing in mind that the tax affairs of so many well respected and highly regarded individuals are likely to be not in order.

Finally, we have argued for consistency and a reasonable level of certainty in tax policy over time in order to reduce inefficiencies as well as inequities that have been shown in recent literature to emanate from uncertainties in taxation.

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⁵ Most fringe benefits that are enjoyed by employees in Tanzania are taxable under the law but in practice they are not. This being the case, a big number of employees (especially those in the public sector) need a tax amnesty if they are not to be considered tax evaders.

APPENDIX: CUSTOMS EXEMPTIONS

A Customs Duty exemption allows the levying of no import duty, or a reduced rate of import duty, which differs from the rate stipulated in the HS coded tables in the Customs Tariff Act.

In Tanzania, exemptions for Customs duties (import duties and suspended duties) are legally documented in three ways:

- ◆ By being listed in the Third Schedule of the Customs Tariff Act;
- ◆ By way of Government Notice. Authority to grant exemption by way of Government Notice issued by the Minister of Finance is under Section 7 (1) of the Customs Tariff Act; and
- ◆ By being approved by the Task Force on Capital Goods and by directive of the Tanzania Revenue Authority

Types of exemptions

- ◆ Goods which are exempt no matter who imports;
- ◆ Exemptions for government and its agencies and employees;
- ◆ Exemptions for diplomats and donors and their employees;
- ◆ Exemptions for the military;
- ◆ Exemptions for non governmental organisations;
- ◆ Exemptions for educational institutions;
- ◆ Exemptions for companies contracted to carry out specific projects;
- ◆ General exemptions for particular companies;
- ◆ Exemptions for particular sectors;
- ◆ Exemptions for particular types of individuals; and
- ◆ Exemptions for capital goods.