

THE INTRODUCTION OF VALUE - ADDED TAX IN TANZANIA: A PLEA FOR ANOTHER POSTPONEMENT

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ABSTRACT

It took four long years of earnest preparations before VAT could be introduced in the UK. Six years of careful examination, deliberations and try outs preceded the introduction of VAT in Korea in 1977. Comparable experiences can be said to epitomise the advent of VAT in France, Italy and many other countries which successfully operate a value added tax of one sort or another. In Tanzania, to the contrary, the VAT gestation period is conceived in terms of only a few months! Worse still there is, so far, no thorough going, pre-determined plan of action for VAT initiation. Yet 1st July 1997 is the day now earmarked for dawning of VAT in Tanzania. In this treatise the basic mechanics of VAT are explained with emphasis on the complicated nature of this indirect tax derivation. Obstacles which a country of Tanzania's attribute is likely to encounter in effecting VAT, superior as it is; and possible measures to combat the same are manifestly spelt out in the following succinct monograph.

INTRODUCTION

In 1991, the presidential Commission of enquiry into public revenues, taxation and expenditure issued its well articulated report. This commission had been appointed in the wake of serious budgetary constraints when the gap between government revenue and expenditure was fast widening as donor money was also becoming increasingly difficult to secure.

It is in this light that the commission recognised the need to widen the hitherto narrow tax base. The present single-stage sales tax system, which brings into the tax net only manufactures and importers leaves a large portion of the Gross Domestic Product untaxed. This was considered one of the major factors which explain the unsatisfactory tax revenue yield in Tanzania.

As a remedial measure, the commission recommended the immediate adoption of a value added tax in place of the present sales tax system. This proposal was accepted by the government and 1993 was the year set for putting into effect the value added-tax system in Tanzania. Preparations for this major change were to start there and a special task force was formed to co-ordinate and oversee the VAT preparatory phase. In this paper we basically support the fiscal policy resolve by the government of the United Republic

of Tanzania to replace the present tax system with a value added tax system. We differ, however from the official position as regards to how soon should these fundamental changes be effected.

In the first place we point out the superiority of value-added tax over other forms of indirect taxation with special reference to some countries which have adopted the former. Then, the basic mechanics of operating a value-added tax system are elaborated in the light of its inherent complexities as opposed to the relatively straight forwardness of the current sales tax system. Furthermore, we discussed conditions currently subsisting in Tanzania, which are likely to hinder the successful introduction and subsequent operation of this higher revenue potential new indirect tax regime. Finally, we recommend specific measures to be undertaken in the preparatory phase in an effort to address the unforeseen drawbacks taking into account the Tanzanian socio-political environment.

WHAT IS VAT IN THE FIRST PLACE?

'Tax sur la valeur adjoute'e', introduced in France in the mid-1950s is the origin of the modern system of indirect taxation referred to as value-added tax—VAT (Whitehouse and Stuart-Buttle,

1993). After France one country after another has replaced the general sales tax system with the VAT system. The United Kingdom and Germany (Wilkinson, 1992); Turkey, Indonesia and Korea (Bird and Oldman eds, 1990); Ghana and Uganda (World Bank Report, 1996); and many other countries both developed and developing.

Several reasons are put forward to explain this world-wide obsession with VAT. France and Germany saw VAT as an improvement to their original single-stage sales tax systems (Wilkinson, 1992), in terms of widening the tax base and spreading tax payments over the whole commercial chain. For Britain, Wilkinson in the same discussion argues that the major motive was harmonisation within the European Union.

As for Korea, a largely agricultural economy, not unlike Tanzania, the following factors are put forward to explain the adoption of VAT (Kwang Choi, 1984):

- Simplification of the tax system by doing away with the multiplicity of tax rates associated with the general sales tax system. The introduction of VAT enabled the synchronisation of all previous rates into only three VAT rates.
- Promotion of exports and enhancement of capital formation as a result of the introduction of a value-added tax system with exports being zero-rated at the final stage of production.
- The introduction of VAT was considered favourable as regards its neutrality in checking mis-allocation of resources and inefficient utilisation of the same.

The Tanzania government, on its part, has decided to replace the present sales tax system with VAT as a result of the recommendations of the Presidential Commission of Enquiry into Public Revenues, Taxation and Expenditure. The arguments in favour of VAT as advanced by the Commission are as follows (URT, 1991):

- The inadequacy of the present sales tax system in terms of its narrow base leading to frequent upward revision of the tax rates;

- Distortionary effects and cascading under the existing sales tax system;
- Higher revenue yield as a result of a wider tax base associated with VAT;
- Simplicity of VAT in terms of determining taxable value, unlike the current system in which detailed legislative provisions for taxable value determination do exist;
- Spreading of tax payments over various stages of the production and distribution chain; and
- Minimisation of tax administration costs due to the self assessment nature of VAT.

Moreover the superiority of VAT as a more effective means of indirect taxation in a largely agricultural economy like Tanzania is indisputable. Experience has undoubtedly shown that for mainly agricultural country, where there have been complaints that the agricultural sector is undertaxed, VAT can go a long way to rectify matters:

".....the value added tax has a lot of self correction built into it. If farmers are exempted from tax, it will be paid by the canners, freezers and other food processors, because they do not have a voucher indicating that the tax was previously paid at the farmer stage. (Actually, the exempting of farmers is likely to lead to higher tax collections than would occur if they were full rate members of the system). If in the system they would be able to deduct purchases of, say tractors, gasoline, fertilisers, seeds etc. Out of the system they can not deduct these items but they are free of tax when they sell directly to the public, for example, at open air markets. I believe that in most countries the amount of inputs for which no deduction can be claimed is higher than

the amount of indirect sales from farmer to public; hence, the assertion that tax revenues are actually increased by exempting farmers from the value added tax” (Harberger, 1985: 317) (emphasis ours)

In line with the foregoing discussion, there remains no doubt that the introduction of VAT in Tanzania is more of a fiscal policy requisite than merely a desirable measure.

VALUE-ADDED TAX EXPLAINED

Value-added tax is a widely recommended model of indirect taxation which slightly differs from those based purely on turnover. It takes the form of a charge on the invoiced value of applicable goods and services supplied to non tax exempt persons. On one hand the business will suffer tax on its purchases, and on the other, it will charge tax to its customers at the time of selling. The former is referred to as input tax, and the latter as output tax net of input tax (Kay and King, 1990)

Let us assume a simplified case of value-added tax calculated on a particular single item of supply in order to illustrate the basic mechanic of how a VAT system works. Note that in practice however, VAT calculations are based on total turnover during a given period and total purchases of inputs during the same period. Consider the commercial chain to consist of producer, manufacturer, wholesaler, retailer and customer, and a value-added tax standard rate of 20%. The amounts of the tax to be paid are as shown in the following table, (all figures in TShs.):

DETERMINATION OF VALUE ADDED TAX

	Cost Price	Sales Price	Input Vat	Output VAT	VAT to be paid
Producer	-	200000	-	40000	40000
Manufacture	200000	300000	40000	60000	20000
Wholesale	300000	450000	60000	90000	30000
Retailer	450000	580000	90000	116000	26000
Customer	580000	-	116000	-	-

Each person in the commercial chain above would be registered as VAT payer. The primary producer who sells his product at Shs 200,000 will be considered to have created this value out of nothing (i.e. value added is $200,000 - 0 = 200,000$). He would thus pay 20% of this value added i.e. Shs. 40,000 which of course he would have charged from his buyer, in this case the manufacturer. In his turn, the manufacturer, who would buy now have processed the primary product so as to increase its value from Shs. 200,000 to turns out to be Shs. 60,000. Out of this amount, the manufacturer would deduct the Shs. 40,000 remainder, Shs. 20,000 to the relevant VAT authority. In effect, the manufacturer would in this way have paid 20% of the value he had added (i.e. 20% of $300,000 - 200,000$). The other VAT payers in the table above would determine their VAT liabilities in a similar manner.

As was pointed out above, any one in the chain with an output tax will be liable to submit it to the VAT authority after deducting the input tax, if any. The total sum paid to the VAT authority represents tax on the value added at each stage in the above chain. In practice, the producer, manufacturer, wholesaler and retailer above would be registered as VAT payers and thus they would be required to charge VAT on supplies made by them i.e. output tax. On the other hand, when these registered VAT payers buy inputs from other registered VAT payers they will also be charged VAT accordingly. This VAT included in the purchase invoices is what is called input tax, and it is deductible normally if the inputs are used or are to be used for business purposes (Taylor and Steward, 1993).

Finally, a VAT system would have to provide for different categorisations of goods and services which are liable to VAT charges. These

goods and services would be classified as either standard-rated, zero-rated or exempt. VAT would be charged on all standard-rated goods and services nor on zero-rated goods and services. The differences between the last two categories is that, while the registered VAT payers can claim credit for relevant input tax on zero-rated items, this is not possible in the case of exempt items. (Stein, 1992).

PROBLEMS INHERENT IN VAT

The proper functioning of a country's tax system depends on the economic, socio-political environment in which it operates. Previous works have shown that the success of a value-added tax system is hindered by, more or less, similar factors that hinder the success of income taxation in underdeveloped economies (for more details see Sijbren, 1978). We would like to put forward an additional argument that these hindrances are more severe for VAT than for income tax because, unlike the latter which is an annual tax assessed only once in a year, the former has to be assessed and paid much more frequently e.g. every month. The intricacies involved in determining the value added and insufficiency or absence of accounting and other related business records, not only provide more opportunity for tax evasion but also presents inability for many would be VAT payers (as the majority would be literary illiterate, accounting wise) to correctly operate the VAT system. The introduction of VAT in Tanzania must be viewed in this perspective so as to devise measures to minimise the hindrance in question.

Mr. P. J. Luoga, a renowned Tanzanian tax academician and currently the Commissioner for Sales Tax and Inland Revenue (the department which will be responsible for VAT administration), had this to say in 1993 after the government had announced for the first time its decision to introduce VAT:

".....One may be tempted to think that VAT can operate very easily under any environment. Our message is that there are a number of relevant issues that should be taken into account when making such decisions. We have

considered the Tax Commission Report and have made it clear that further studies and preparations are required. This must be so even if VAT is a naturally superior tax than the present sales tax system." (Luoga, 1993:17)

We wish to express our support for the above line of argument by pointing out conditions currently obtaining in Tanzania, which are likely to jeopardise the proper functioning of a value-added tax system in the country:

- Tanzania is a predominantly subsistence economy with little commercial integration. Consumption items are to a large extent produced informal sector artisans. Examples include furniture, utensils, masonry services etc. These are generally made to order and sold directly to the consumer with hardly any documentation being made and kept.
- VAT requires the filing in of complicated forms and returns. This entails a high level of literacy that is usually not found among craftsmen, cottage-type industries, the "machingas and among a very large proportion of the existing substantial informal sector of the Tanzanian economy.
- The complete reliance of VAT on records provides, not only opportunity but also temptation to make false returns.
- Checks upon written records are not a reliable enforcement measure because books of accounts are hardly kept at all by the majority of potential VAT payers in Tanzania, and even where such books are maintained, they are likely to be neither reliable nor honest.
- The tradition of voluntary compliance, that is basic ingredient for the successful operations of VAT simply does not exist in Tanzania. Most people define their interest in the narrowest possible and will pay taxes only when they are inescapable. Evading tax is not considered perfectly normal but an act of bravery.

- VAT administration is not an easy task. Comprehensive auditing of taxpayers' accounts is mandatory and many more collections areas would be needed. In a corrupt and inefficient society that we are, VAT would greatly serve to compound the problems of internal control over the tax assessment; its collection and also its accounting.
- Lastly, VAT would entail the many more people filing tax returns and this will raise their awareness on the amounts being paid to the government as taxes. This by itself, requires quite broad-based political support which may be lacking in a country emerging from the wounds of the hitherto public mistrust of the government; and especially, given the neo-pluralist society that Tanzania is becoming today.

All in all, the government has, all along been reiterating its resolve to introduce VAT in Tanzania. Originally, the intention was to introduce VAT with effect from July 1993 as per recommendations made in 1991 by the Presidential Commission of Enquiry into Public Revenues, Taxation and Expenditure. This was later on rescheduled to January 1994; and during the last budget session in June 1995, the minister for Finance informed members of parliament about VAT preparation in the following terms:

".....the Government still continues with preparations for the introduction of a new system of collecting sales tax, stamp duty and hotel levy using value added tax. This system will help to simplify tax collection....." (1995/96 Budget Speech: 22) (Translation from Swahili by the author)

Talking to journalist in mid May this year, Mr. M. E. Sanare, Commissioner General of the Tanzania Revenue Authority, was confident that VAT will, at last, start in July 1997 (Business Times 17/05/96). Much as we declare our complete support for the decision to introduce VAT in Tanzania, we wish, however, to point out our disappointment

on the inertia within the relevant authorities as regards necessary ground work before VAT is operationalised. Efforts taken so far to prepare the country for the introduction of VAT leaves a lot to be desired, and there is a feeling that this exercise is being taken too lightly.

With respect to instituting VAT it is important to note that although some countries have managed it smoothly and successfully, others have not done nearly so well for example Guatemala (Bird and Oldman eds, 1990) and Ghana (World Bank, 1996). Tanzania must, therefore take stock of lessons from other countries by carrying out adequate preparations for tax administrators as well as the general public before the actual adoption of VAT.

".....In Ghana, for example a VAT was recently introduced which rapidly increased inflation as many more firms than those eligible began to charge the VAT. Subsequently the VAT was temporarily withdrawn. This highlights the importance of adequate preparatory work prior to the implementation of VAT." (World Bank, 1996:7).

As for neighbouring Kenya, matters have not been so smooth lately either:

"Recently a weekly newspaper reported an increase of VAT evasion in Kenya. The tricks were reportedly being done in broad daylight. Retailers were displaying different prices to indicate where VAT was included or excluded. This tempted the public to evade tax by preferring lower prices without VAT." (Business Times, 17/05/1996)

WHAT NEEDS TO BE DONE ?

It is our belief, judging from the level of preparations undertaken so far, that much more work remains to be done before VAT can smoothly be introduced in Tanzania. These preparations need enough time, (certainly not a

couple of months!) as they did in other countries like the UK, France and Italy. (Luoga, 1993). After the recent radical restructuring of the tax administrative machinery, the much heralded, Tanzania Revenue Authority is still struggling to its feet with in-house clearing and setting-up matters, **not tax collection**, being at the top of its immediate agenda. To introduce a complete new tax system presently will be expecting too much from the infant body. Again, Korea is a good example in this regard:

“Careful examination and long preparations preceded the introduction of VAT in Korea.....Although the law was enacted on 22nd December 1976 and took effect on 1st July 1977, the decision to introduce VAT was made in 1971”
(Kwang Choi, 1984:371)

Sales tax, one of the taxes to be replaced by VAT, accounts for more than 40% of the total tax revenues in Tanzania (see Appendix). This means that the effects of a VAT failure, to the economy in general and the government in particular would be so catastrophic that it is completely irrational to take the risk. We thus suggest here possible aspects to be included in any effective program for VAT preparations. These suggestions are an adaptation of the Korean experience as documented by Kwang Choi (1984).

Solicitation of Views and Ideas

Initially, a VAT workshop should be convened and it should be attended by politicians, tax administrators, tax academicians, accountants, representatives of the business community, representatives from the informal sector etc. Ideas should be solicited on how effectively can problems associated with VAT be tackled in the Tanzanian context.

In order to benefit from the experience of other countries, the government should send a team of tax administrators, business people and academicians to visit a number of countries which have already introduced VAT. The countries to be visited should include developed and developing; those which have been very successful and those not so successful.

Preparing Tax Collectors for VAT

A staff training program should be devised and implemented through seminars and short courses. A staff handbook for officials who would be dealing with VAT should be prepared and circulated well in advance. Towards the end of the program, nation-wide trial exercises designed in such a way as to involve as many VAT payers and collectors as possible, should be carried out on specified dates. The Institute of Tax Administration (ITA) and the Institute of Finance Management (IFM) should be actively involved from the formulation to the implementation stages of the preparation program so that both practical and theoretical inputs can be taken into account.

Compatibility of VAT Law with External Factors

The ability to administer VAT is a function of a large number of factors. In the formulation of the VAT statute external factors have to be taken into account, as it is the case for any new tax law. These include the degree of literacy among potential taxpayers, the size of the monetary economy, the adequacy of book-keeping, the public attitudes toward taxation and the efficiency of tax administration services. A lot of difficulties with VAT can be avoided if the intrinsic complexity of the tax is compatible with the above mentioned external factors. (Bird and Oldman eds, 1990)

Administrative Efficiency and Cost Reduction

The Tanzania Revenue Authority should start preparation to merge the Sales Tax and Inland Revenue Department with the Income Tax Department into one Inland Revenue Department which will be responsible for VAT as well as income tax administration. As we pointed out earlier, VAT can be administered in a similar manner to income tax in terms of returns and other forms to be filled in as well as enforcement measures required. In many instances VAT payers can evade not only VAT but also income tax by suppressing both purchases and sales. This counterbalances the incentive we pointed out earlier for a VAT payer to request invoices/receipts for all purchases he or she makes in order to increase the input tax credit.

As for Korea, Kwang Choi says:

"A high degree of co-ordination between the staff in-charge of VAT and those in charge of direct taxes is very important. It is an open secret in Korea taxpayers cheat on their sales not to evade the VAT but to evade personal and corporate income taxes. Operation of a VAT resembles that of the income tax more than that of the others and an effective VAT greatly aids income tax administration" (Kwang Choi, 1984: 387)

Such close co-ordination between VAT and direct taxes through a merger will also help to reduce collection and compliance costs which will otherwise shoot up with the introduction of VAT.

Public Support and General Understanding of VAT

An elaborate information and education program aimed at potential VAT payers and the public in general should be formulated and implemented. The program will describe the operation and effects of VAT through newspapers, radio, television and dissemination of information by trade associations. VAT guidebooks, handbooks and brochures will also have to be prepared for general distribution. Films explaining VAT can help a lot in this program and; whenever possible VAT should be explained in public meetings and similar gatherings.

The success of VAT will depend to a large extent on the degree of voluntary co-operation forthcoming from business community. To secure this co-operation, the government, from the start of the preparation program should engage the full participation of the business community in all VAT consultations and information dissemination ventures. The Tanzania Chamber of Commerce, Industry and Agriculture; the Confederation of Tanzanian Industrialists; regional chambers of commerce and like organisations are examples of organs with which the government should work closely.

In addition, the government should try to mobilise the support of political parties so as to create the much needed public support for VAT

in particular and tax compliance in general. Grassroots support for VAT will only be possible if there is general consensus in the country as to the necessity for the government to be adequately financed through internal sources for true and sustainable development of the majority of Tanzanians. This entails goodwill and commitment of all citizens regardless of political or ideological affiliation.

CONCLUDING REMARKS

In this paper, we have dwelt on the foundation of a VAT system of indirect taxation as well as the desirability of introducing such system in Tanzania. More significantly, we have made an attempt at highlighting some possible snags that Tanzania is likely to come across in the course of introducing VAT. In this regard we have tried to point out the contents of the "standard groundwork program" which Tanzania must assume as a pre-requisite for a successful initiation of value-added tax. In so doing, we have extensively borrowed from the experience of countries where VAT already exists.

Unfortunately, this factor is missing going with what has so far been accomplished in the name of VAT preparations. This author who has had a rich personal experience working in the Sales Tax and Inland Revenue Department (and maintains close contacts there), and lecturing in Sales Tax Law, is aware of the level of unpreparedness among the would be VAT administrators as well as among the would be VAT payers.

We do hope, therefore, the relevant authorities will measure up to the challenge we are hereby throwing; and take up this presentation as a basis for the formulation of a comprehensive, properly designed and well co-ordinated VAT preparation program. This envisaged program implies that VAT can, and should not be hurriedly introduced in Tanzania, in July 1997 as planned, for the all too obvious reason that the level of preparedness reached so far is quite unlikely that it can formulate, let alone implement, an ideal VAT preparation program in its very first year of operation.

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APOLOGY

In the previous issue vol. 4 No. 2. the paper titled the case for Privatisation carried the wrong spelling of the last author's name. The correct name is J.P.W. Shunda and not SHILINDA.