

## **THE VALUE ADDED TAX IN TANZANIA LESSONS FROM EXPERIENCE OF OTHER DEVELOPING COUNTRIES:**

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### **Abstract**

*Most of developed and developing countries have adopted VAT with the main object of base broadening and increasing revenue. The most popular is consumption type VAT levied on the basis of destination principle. Our analysis of the experience of some developing countries has shown that a VAT that extends to retail level is preferable to pre-retail VAT. In order to avoid production and consumer distortion VAT should be imposed on both goods and services at a single (uniform) rate. However, the application of zero-rate on essential goods is inevitable in order to help poor households. To create progressively and increase revenue we suggest that an excise system be applied on luxury and traditional excise goods. The experience of other developing countries provides us with recommended lessons to Tanzania.*

### **INTRODUCTION**

The past three decades are characterised by worldwide wave of tax reforms, from which clear patterns are observable. In developed countries significant elements of these trends have included an increasing reduction of personal income tax rates and categories, and base broadening.<sup>1</sup> In developing countries there has been an increasing shift towards more comprehensive indirect taxes levied at rates which are much more uniform than in the previous taxes (see Gillis, 1989 for a detailed discussion). Most of these countries replaced sales taxes with broad based value added tax (VAT).

The reasons for adopting the VAT differ from one country to another, but the main argument is that a well designed vat can provide greater revenue and economic efficiency, that is, it can be operated with less administrative and compliance costs.

Tanzania, like these other developing countries is not an exception because she contemplates the adoption of VAT sooner or later. Preparations have already started with an establishment of VAT Implement Project since 1994. The project comprises of implementation team which is responsible with inter alia training

and publicity.

Since VAT is new in Tanzania, and the literature relating to such tax is scarce; this paper endeavours to provide readers with general description of VAT, experience of other developing countries which administer VAT; what lessons are drawn from such experience and recommendations for the design of an efficient VAT in Tanzania.

The paper starts in part two by looking at the definition and concept of VAT, the mechanism and forms of VAT. Part 3 deals with experience of other developing countries in as far as VAT coverage, VAT base and rate structure are concerned. The paper then proceeds to evaluate these three essential features of VAT. In part four the paper attempts to discuss the main lessons of the right design of VAT in Tanzania. Finally, part five summarises the paper and points out some recommendations to policy makers.

### **DEFINITION AND THE CONCEPT OF VALUE ADDED TAX**

Value added tax can be defined as a tax imposed on value added. It is a transactions tax imposed on all goods and services collected on sales at all stages of production and distribution. Value

Table 2.1 HOW VAT WORKS

FIRM	INPUT VALUE (VAT EXCLUSIVE)	INPUT VAT	PRICE OF INPUTS (VAT INCLUSIVE) (1+2)	VALUE ADDED	OUTPUT VALUE (VAT EXCLUSIVE (1+4))	VAT ON OUTPUT	OUTPUT PRICE (VAT INCLUSIVE)	GROSS VAT LIABILITY	NET CREDIT	NET TAX PAID TO GOVERNMENT
1. Supplier of raw material	200	0	200	100	300	30	330	30	0	30
2. Manufacturer	300	30	330	500	800	80	880	80	30	50
3. Wholesaler	800	80	880	200	1000	100	1100	100	80	20
4. Retailer	1000	100	1100	200	1200	120	1320	120	100	20
5. Consumer	0	0	0	0	1200	120	1320	120		120
Zero rating at retailer level	1000	100	1100	200	1200	0	1200	0	100	0
Exempt at retailer level	1000	100	1100	200	1200	0	1300	0	0	100

added, on the other hand represents the value of processing and handling purchased input by the firm, these include raw materials and capital goods and services. The firm in turn sells its manufactured goods (outputs) to other firms or ultimate consumers. Value added is, therefore, the difference between inputs of the firm and its outputs. It is, basically, the sum of wages and salaries, interest payments and profit before tax (Aaron, 1981). The concepts of VAT can be viewed as a tax on the value of a commodity<sup>2</sup> paid by the seller who eventually passes such tax forward to the purchaser of his output through increased prices equal to the gross amount of the tax.

## HOW VAT WORKS

From the above discussion value added taxation is a comprehensive method of taxing and collecting a general sales tax from final consumers of both domestically produced and imported goods, and services by instalments, unless they are specifically exempted.<sup>3</sup> Thus, each firm is liable to pay VAT on the value of its sales, but the gross liability is reduced by tax credit which equals amount of tax already paid on purchases of inputs.

### Illustration

Our illustration is based on the assumption that the supplier of raw materials produced them himself by use of labour. If for example a uniform rate of 10 percent is imposed at every stage of production - distribution, then the supplier of raw materials to a manufacturer will pay VAT on his sales. The manufacturer in turn will also pay VAT on his sales of finished goods to the wholesaler. The wholesaler distributes the goods to retailers who eventually sell them to ultimate consumers. This process is summarised in Table 2.1.

Table 2.1 shows that total tax paid amounting to shš. 120 equals 10 percent of the consumer price which is shš. 1,200. From this illustration it is clear that VAT is a tax on domestic consumption in the home market because it falls on the final consumer. The example, also, shows that each person deducts tax paid on his input from gross tax liability on his output for each

specified period of collection and remit the net tax to the government.

In principle VAT is passed forward in full to the final consumer. In certain cases, however, where VAT is imposed on certain goods but not on their close substitute, consumers tend to shift from the taxed goods and purchase the substitute.

In the long run as consequence, will move out of the industry which produces the taxed good and more of the untaxed good would be produced. Hence, in order to avoid such distortions, VAT should cover almost every commodity.

From the table we can, also, note that the effect of zero-rating (sometimes referred to as exemption with tax credit) at the retail level is that, all VAT is removed from zero-rated goods and credited to the retailer of the same. Furthermore an exempt trader or a retailer who sells exempt goods pays tax on his inputs but he cannot claim a tax credit on the same.

## FORMS OF VALUE ADDED TAX

There are three types of value added tax namely: Consumption Type VAT, Income Type VAT, and Gross Product VAT.

### The Consumption Type VAT

This type of VAT allows each firm to deduct the VAT paid on both capital and intermediate inputs from the gross VAT liability on its output sales to other firms or ultimate consumers. Eventually only sales to final consumers (which is equivalent to the retail price) are taxed. This can be illustrated as follows:

$$T_i = tS_i - tP_i,$$

Where,  $T_i$  is VAT payable at stage  $i$ ,  $S_i$  and  $P_i$  denote sales and purchases at stage  $i$  respectively, and

$t$  is the tax rate

Hence,  $tS_i$  denotes gross VAT liability on output sales at stage  $i$ , and  $tP_i$ ,

denotes credit for tax paid on purchase at stage  $i$ .

Assuming that at the first stage of supplier there are no purchases, then we have three production - distribution stages namely; manufacturing, wholesaling and retailing. The aggregate tax liability can, therefore be written as:

$$\sum_{i=1}^3 T_i = (S_3 - P_i) = tS_3$$

Where  $S_3$  denotes sales to final consumers. (See Mclure, 1973 and Cnossen, 1982).

Thus, the total amount of VAT which is independent of the various stages it has passed is a function of the tax rate and the final price of the commodity. That is,  $VAT = f(r,p)$ , where  $r$  is the tax rate and  $p$  is the final price of the commodity to ultimate consumers.

Shoup (1969), argued that an advocate of a consumption type VAT is that, it need not require any adjustments for depreciation on capital goods in the following years. Hence, it grants 100 percent accelerated depreciation which is equivalent to tax exemption (for a detailed discussion see Shoup, 1969: 301-302) Indeed, there is no tax imposed on value added in capital goods and accumulated inventory because these will be consumed in later periods.

In an open economy with international trade, the consumption type of VAT is levied on a destination basis. Basically the destination principle includes the value of imports to the VAT base, although they do not represent any value added to the national product. On the other hand exports are part of value added domestically. Nonetheless, they are not consumed within the country of production, hence, they must be deducted from the VAT base. In principle deliveries for own consumption and services rendered for own benefit must be included to the VAT base.<sup>4</sup> This would minimise avoidance of tax because the tax payer has to record such transactions notwithstanding that he has not received any cash for the goods or services.

### The Income Type VAT

The income type VAT allows a full tax credit on intermediate inputs only. Tax credit on capital

goods is restricted to a proportion of their value which is equivalent to depreciation. If, for example, capital goods are allowed an annual depreciation using a straight-line method at a rate of 10 percent on the historical cost, assuming that such goods have expected life of five years with no salvage value, then the tax credit in each of the five years will be only 10 percent of VAT paid on new investments (Mclure, 1937). The limitation of this type of VAT is that it does not permit full deduction of VAT on capital intensive methods of production. Basically the philosophy is that income type VAT promotes employment because firms have to employ more labour force in order to avoid tax.

### The Gross Product Type VAT

The gross product VAT allows tax credit on intermediate goods which are used up in the process of production in current period only. This type of VAT does not allow tax credit on inventory accumulation and capital goods, and the deduction of depreciation in subsequent years. Certainly, gross product VAT strongly discriminates employment of capital equipments in production because these are fully chargeable to VAT, hence, it discourages investment in the economy. Nevertheless, it creates employment because industries have to employ more labour force than capital equipment.

Furthermore, gross product VAT does not conform with equity criterion because other firms use more capital goods which are subject to VAT whereas other firms use more intermediary goods which are eligible for tax credit.

### VAT EXPERIENCE OF OTHER DEVELOPING COUNTRIES

Goode (1984: 157) has remarked that, ".....the value added tax (VAT) is the most important tax innovation of the second half of the twentieth century". This statement is evidenced by the fact that during 1960s and 1970s most of developing countries directed their attention to value added tax. The main objectives of shifting to the VAT were to rationalise their sales taxes and improve tax revenue. This section

endeavours to analyse experiences of other developing countries in as far as administration of VAT is concerned, and draw some lessons to Tanzania. Our analysis is, however, limited to a sample of only nineteen (19) countries. These include Algeria, Argentina, Brazil, Chile, Colombia, Cote d'Ivoire (Ivory Cost), Equador, Kenya and Korea. Other countries are Malaysia, Malagasy Republic (Madagascar), Malawi, Mauritius, Morocco, Niger, Senegal, Togo, Tunisia and Uruguay.

### VAT Coverage, Base and Rate Structure

TABLE 3.1

#### VALUE ADDED TAXES IN DEVELOPING COUNTRIES

Country	Year	Scope		Rates (Percents)		
		Introduce	Coverage	Tax Base	Standard	Lower
Algeria	1960	M	G+CG	25	75, 11.1	429, 66.7
Argentina	1975	R	G+ST	13	X	-
Brazil	1967	R	G+CG	20.5	-	-
Chile	1975	R	G+S	18	-	-
Columbia	1974	R	G+ST	10	0	35
Cote d'Ivoire	1960	M	G+CG	25	11.1	35.1
Equador	1970	R	G+ST	10	X	-
Kenya	1990	M	G+ST	18	X	35, 500, 100
Korea	1977	R	G+S	10	X	-
Malagassy Republic	1969	R	G+S	15	X	-
Malawi	1989	M	G	35	X	Variable
Mauritius	1983	W	G	5	X	-
Morocco	1986	W	G+S	19	X, 7, 12, 14	30
Niger	1986	R	G+S	17	X, 10	25
Senegal	1990	R	G+S	20	7	50
Togo	1984	R	G+S	14	3	-
Tunisia	1988	R	G+S	17	X, 6	29
Uruguay	1973	R	G+S	22	X, 12	

Table 3-1 shows that twelve countries levy a comprehensive VAT which extend through the stage (R-VAT). Two countries (Mauritius and Morocco) extend the VAT through the wholesale stage only (W-VAT), whereas four countries namely Algeria, Cote d'Ivoire, Kenya and Malawi impose VAT at manufacturing and importing level (M-VAT). Experience shows that most countries which started with a pre-retail VAT extended the tax to the retail stage, for example Senegal and Tunisia have done so in recent years (Crosen, 1994).

The VAT system adopted in most developing countries were designed to cover a wide range of domestically consumed goods and services. Our analysis shows that nine countries

tax goods and services comprehensively (G + S). Three countries (Algeria and Cote d'Ivoire) impose VAT on goods and capital goods (G + CG). Algeria and Cote d'Ivoire which inherited VAT from the French exclude services from the base because they are subject to a separate turnover tax levied at differentiated rates. Nevertheless construction and building contractors, and hire purchase companies are subject to the VAT in the two countries respectively. On the other hand Brazil does not tax services because its constitution empowers municipalities to impose turnover tax on the same.

Malawi and Mauritius confine the VAT on goods only (G). The four countries (Argentina, Colombia, Equador and Kenya) impose VAT on goods and tax services selectively (G + ST) by explicitly enumerating them in the law. All sample countries except Brazil make use of the consumption type VAT based on destination

principle. Brazil is exceptional in two aspects because it uses the gross type VAT and the origin principle which includes exports to the tax base and excludes imports (Shoup, 1990). The origin principle creates distortions on both international trade and consumer choice. Essentially, taxation of exports would discourage exporters from exporting, thus value of exports would decrease. Moreover prices of taxed exported goods would be high, as a consequence, such goods would be less competitive in the world market. Definitely the country's balance of payments would very much be affected.

On the other hand, since imported goods are tax free whilst domestically produced goods of the same nature are liable to VAT, demand for the latter would decrease because people would consume more of imported goods which are cheaper. Consequently what happens in such a situation is that factor cost would fall in the industry producing taxed goods and in the long run recourses would move out of that particular industry. The choice of the rate structure is of significant importance for achieving equity and efficiency criteria of a good tax system. The choice between a single or multiple rate(s), and the number of categories in the case of the latter, is a common problem faced by all countries that adopted VAT. Table 3.1 shows that three countries (Algeria, Kenya and Morocco) have multiple rates. These countries impose higher rates on luxury consumer goods, possibly with an aim of introducing an element of progressivity and income distribution. Five countries (Colombia, Cote d'Ivoire, Niger, Senegal and Tunisia) have higher than standard VAT rates. Togo and Uruguay have lower and standard rates only. Interestingly, eleven countries exempt (x) essential commodities in the household basket of lower-income groups. Out of these, eight countries have a single rate VAT. Colombia is the only country which zero-rate commodities regarded as essential.

Essentially, all sample countries have excise systems confined mainly on the traditional excise goods such as alcohol, tobacco, cigarettes and spirits. Very few countries, however, have an intermediate or extended excise system, instead of a higher VAT rate. Obviously, such countries do so in order to discriminate against

luxury goods and enhance progressivity because they have a single rate VAT.

## **Appraisal**

Any country which contemplates to adopt Value Added Tax (VAT must consider three essential features namely, coverage (who should be taxed?), the tax base (on what?) and rate structure (to what extent?).

## **VAT Coverage**

The experience shows that, (as indicated above) most countries have opted for a VAT that extend to a retail stage (R-VAT). Oftenly the VAT which stops at manufacturing or wholesale stage has been given a benefit of the doubt; albeit, we can argue that administratively it is easy and less costly to levy VAT at pre-retail stage because business units are typically larger with fewer tax payers who are literate and able to keep proper records and accounts. Nonetheless pre-retail VAT has some shortcomings which are discussed below.

If VAT is levied at manufacturing level value added at subsequent trading and distribution levels would not have been subjected to tax. Also it becomes difficult to determine how to treat sales at different trade levels, transfers between related parties and sole distributors, such cases would lead to tax avoidance another problem which arises is under-statement of the value of taxable goods during a sale between registered firms and non registered firms which are related. This would result in tax evasion which would definitely decrease the integrity of the VAT.

Equally, if VAT is levied at wholesale stage a large number of wholesalers would perform the role of retailers and sell to consumers. This provides an incentive of pushing forward their operations beyond the taxed stage resulting in loss of revenue. To alleviate this problem there must be a threshold established in order to exclude wholesalers who would be below this line. Those would probably not be required to register for VAT purposes. Practically it would be difficult to establish the threshold and apply to individual cases, hence, it would complicate administration of VAT resulting in increased administrative costs.

At this juncture we can argue that the best VAT covers the whole production-distribution process through the retail stage. Nevertheless an advocate against including the retail stage in the VAT net is that it comprises of numerous small traders who are illiterate and find it very difficult to keep records and accounts relating to their business operations. But an issue of small traders should not be considered as a barrier to extend the VAT to retail level. Middle-size and large retailers which are presumed to keep adequate accounts should be registered.

Furthermore, special measures should be designed for VAT treatment of small traders. In conclusion therefore, the criteria for tax coverage should be the size of the firm regardless of the stage at which it is situated.

### **VAT Base**

Ideally a VAT should cover a wide range of domestically consumed goods and services. Taxing one commodity but not its substitute would distort consumer choice and minimise the tax revenue. Delivery of goods for own consumption and services rendered for own benefit should be included in the tax base. Nonetheless, certain services are difficult to tax such as financial transactions and insurance, health, education, social and religious services. Hence, some concessions must be made on administrative grounds. The practice of many countries is to exempt such services.

Taxation of services can be done in two ways:

#### **(a) Integrated Approach:**

All services are taxable under the law except those specifically exempted. Most countries which follow this approach exempt social services relating to health care, education, welfare and cultural activities, financial transactions and insurance. There is an advocate for zero-rating social services. If this would be so institutions rendering such services would require registration, returns and refunds which is not the case if they are exempted, because there would be no credit given for the VAT on purchases. Hence, the exemption approach seems best for social services

to avoid administration complications.

#### **(b) Selective Approach**

All services are exempt from tax except those that are explicitly enumerated as being taxable. Services that may be taxable under this approach include laundry, dry cleaning and dyeing services, personal care services such as saloons, beauty shops, hotels and restaurants.

More services are likely to be taxed under the integrated approach because in principle it is difficult to obtain an exemption when all services are taxed. In addition, it is easier to define what is not taxable than what is liable to VAT.

As discussed earlier, taxing capital goods discriminates against capital-intensive methods of production. On the other hand, taxing capital goods and granting of full and immediate tax credit thereon, has an important advantage because the tax office does not have to define capital goods. Also a full credit for the tax on capital goods would facilitate auditing process.

Similarly, levying the tax on intermediate goods should be avoided. A clear advocate for this principle is that, intermediate goods are purchased not by final consumers but by producers, hence if such goods are taxed, the burden of the tax falls on consumers in the end. Furthermore, consumers will have to pay for the distortions of production decisions which result from such tax on these goods. In the final analysis tax on intermediate goods would lead to inefficiency in production. In general VAT avoids these problems, albeit some might arise if such goods are exempt from tax. The reason is that if intermediate goods are exempted no tax credit is given for the VAT on them, as such the tax element would be added to other costs of production which eventually are transferred to ultimate consumers. Thus exemptions should be avoided as they create distortions.

#### **Rate Structure**

A country that levies a broadly consumption VAT may be expected to have a single (uniform) rate of tax on all commodities. This has obvious administrative advantages because both administration and compliance costs would be

much lower than in a situation of having differentiated VAT rates. It is true that traders would not be able to keep separate accounts for differentially rated commodities. As such they will have to hire an accountant or a tax consultant who can do the work, thus increasing their compliance costs. Moreover, compliance control would become more complicated, because the physical flow of commodities must be audited in addition to the financial flow of goods. This is obvious because taxpayers can issue invoices that show the correct financial amounts but the wrong type of commodities and rate. Indeed such situation in developing countries would increase administration costs due to limited administrative capability.

Another argument is that if commodities which consumers can readily substitute for each other are taxed at very different rates, then the tax system would distort their choice between such commodities. Such distortions, indeed, will impose an excess burden of the tax which is over and above the inescapable costs associated with raising revenue.

These arguments might establish a presumption in favour of a single (uniform) VAT rate. In principle a single rate minimises distortions of resource allocation because there is no discrimination between methods of production. On the other hand, consumer choice distortion can be eliminated because different consumer goods and services are taxed at a uniform rate.

But nonetheless, a single rate has a disadvantage as far as income distribution is concerned. It is argued that a uniform rate is likely to be regressive because consumption as a share of income falls as income rises. As a result low income households spend proportionately higher amounts on taxable goods and services than higher income households. Thus, a VAT levied at a uniform rate would fall more heavily on the poor than on the rich. This violates the prevailing equity principle which stipulates that people's tax payments should be proportion to their income.

We can, therefore, argue that the best method is to impose a reduced rate on essential goods and services that are heavily consumed by low income households. The use of exemptions would also lessen the regressivity and facilitate

administration if they are carefully designed. However, they are frowned upon literature because they cause cascading effects. Another method to help poor households is to apply a zero rate on essential goods rather than a reduced rate. We can, however, argue that this is an inefficient way to help the poor. If for example, we consider a normal good which is heavily consumed by both low and high income households (e.g. sugar or rice) with rich households would benefit more in absolute terms while the poor would benefit less.

An element of progressivity can, therefore, be introduced in the tax system by imposing higher rate on goods that are considered as luxury and consumed by rich households. The general implication is that the tax system has to apply two or three rates. The problem arising in this case is deciding on which goods should a higher rate be imposed. Ramsey rule of inverse elasticity suggests that goods with more price inelastic demand should be taxed at a higher rate. The rationale is that if inelastic goods are taxed at a higher rate, more revenue would be yielded because demand only falls a little (see for example Heady, 1992: 19 - 20).

But our objective is to have an equitable and efficient tax system and we have so far noticed that differentiated rates increase distortionary costs. In order to enhance equity and efficiency and create progressivity, instead of applying a higher rate, the preferred solution is to have a zero-rate on essential goods and services, and a single (uniform) rate on other goods. The revenue that would be lost, may be compensated by introducing excise taxes on luxury increase sharply with increasing household income, so more revenue can be collected (for more details see Tait, 1988 and World Bank 1991). No doubt, this would also provide an incentive for people to work harder in order to earn more income, thus enhancing productivity and increasing national product. Excise taxes may also be imposed on traditional excise goods (alcohol, beer, cigarettes, and spirit) which are price inelastic.

## **LESSONS TO TANZANIA**

### **Tax Coverage**

The first lesson from experience of other developing countries relates to the question who should be taxed? The VAT which stops at



manufacturing (M-VAT) or wholesale (W-VAT) level has so many distortions and administrative complexities, hence it should not be contemplated (See Section 3.2.1). In order to avoid such distortions Tanzania should consider the adoption of a consumption type VAT that extends to the retail level and levied on a destination basis.

Shortfall of this the expected revenue would never be collected as this would have no difference from the current single stage manufacturers sales tax. But nevertheless an issue of small traders poses a controversial problem the discussion of which is essential here. The general experience of other developing countries is that small traders lack sufficient knowledge of record keeping due to illiteracy and Tanzania is no exception. Certainly better record keeping would increase efficiency of businesses, however the outcome for small firms would be increase burden in the form of compliance costs. The philosophy is that most of these traders have to seek professional advice for bookkeeping and preparation of VAT returns giving rise to increased compliance costs. Compliance costs are those incurred by taxpayers in order to comply with tax statutes, this is so due to complexities and uncertainties about such statutes. Sandford and Godwin (1983) study, revealed that compliance costs of VAT fall much heavier on small firms than medium and large firms.<sup>5</sup>

The aim of tax authorities is to achieve one of the principles of a good tax system which is efficiency (economy). Thus to minimise high compliance costs of small traders and relatively high administrative costs compared to the revenue involved, an appropriate small traders exemption can be used to exclude most of them from the requirement to register for VAT (see for example OECD, 1988). The tax authority however, must specify the exemption limit below which very small traders would be given discretion to register or not to register. To identify such threshold the criteria used include turnover, value added, capital assets, number of employees, number of establishments as well as number of combination of two or more of these criteria (Tait, 1988: 111).

This scheme is simple and reduces administration costs because the tax department would concentrate on large business only where the revenue is at risk, whereas compliance costs

would be minimised because exempt small traders are not required to keep records. We can, however, argue that the system encourages evasion because a trader who is slightly above the threshold would split his business into small units. This limitation can be redressed by requiring traders who have more than one establishments to aggregate their sales turnover in a single return. Furthermore, the system discriminates large firms against small ones, thus, discouraging voluntary compliance. Tait (1988) argued that the exemption limit should be as high as possible so as to exclude a large number of very small traders. This could definitely enhance efficiency and minimise the above mentioned distortions.

Apparently, presumptive assessment techniques are helpful in collecting some revenue from traders just above the exemption limit. The volume of purchases seems best proxy for estimating the VAT liabilities as this can be done without spending too much time on the exercise without giving the tax office too much discretion. More details relating to special schemes for treatment of small traders in case of Tanzania will be dealt with in a separate study.

### **Tax Base**

The second lesson relates to the question on what should VAT be imposed? Tanzania should make effort to include all goods and services to the VAT base. However, in a case of difficult to tax services, such as banking and insurance transactions, social and religious services, health care and education, these should be excluded from base by exempting them. The integrated approach is preferable to the selective approach (See Section 3.2.2). The current practice under the sales tax system seems to apply the selective approach because all taxable services are explicitly enumerated in the law (See Shekidele, 1996). Using the selective approach under the VAT would give rise to administrative problems as more people would apply for exemptions even where the type of the service is one which is taxable. This would require tax officials to deal with such cases instead of dealing with more important issues for the purpose of collecting more revenue. Hence, administrative costs would be increased in terms of money and time.

## **Rate Structure**

The third lesson is that multiple rates should be avoided in order to enhance efficiency. The implication is that a VAT should be levied at a single (uniform) rate. Nevertheless a special arrangement for helping poor households should be designed without affecting the collection of the desired revenue. To do so a zero-rate should be imposed on essential goods, primarily unprocessed foodstuffs and exports. In order to create progressivity and increase revenue, excise duty should be levied on traditional excise goods and luxury goods (as is the case under the sales tax system). Luxury goods would include private cars, TV sets, cosmetics and perfumery, jewelry and precious stones, clocks and watches, radios, electric appliances, cameras and musical instruments, weapons and ammunition. These goods are in fact income elastic and so the government is sure of collecting more revenue (see section 3.2.3)

## **The need for Period of Preparation, Publicity and Education**

The VAT is a complicated tax to administer especially in the Tanzanian environment. It requires details record keeping; and honesty, a culture which is missing in Tanzania. Essentially VAT requires literate taxpayers who are willing to maintain basic accounts and tradition of voluntary compliance before and after adoption of VAT? How can Tanzania win on this basis?

Adequate period of preparation is crucial so as to establish education programmes for both tax officials, traders and the public at large. Such programmes have already started and recently the VAT implementation Team conducted a short course for tax officials. Similarly, the National Board of Accountants and Auditors (NBAA) held a seminar on VAT which attracted participants from various organisations in Tanzania. This definitely, is a good start, but, it should be a continuous process and such education campaigns should involve the public in general.

An introduction of VAT creates fears of increased compliance costs and prices. To combat such fears it would be necessary to explain the

VAT mechanism to people. By doing so, people will be aware of the VAT, it would gain public acceptance and would, minimise tax evasion and encourage voluntary compliance. Public education before and after the adoption of VAT is necessary. The use of leaflets and posters written in a clear, and simple non-technical language; and TV and radio programmes will be of considerable benefits in educating the public and minimising learning costs of potential VAT payers.

Seminars and Workshops should be conducted for taxpayers so as to enable them acquire the knowledge of record keeping and preparation of invoices which are crucial documentary evidence in the administration of VAT. Taxpayers should be cautioned that in the absence of such invoices it will be very difficult to be allowed VAT credit against their previous VAT liability.

In addition, education visits by tax officials to the premises of taxpayers would strengthen and improve the education campaigns. As a result, taxpayers and the public in general would develop a positive attitude towards the VAT system. This would in turn create a good harmony, encouraging voluntary compliance leading to efficient VAT administration.

## **SUMMARY AND RECOMMENDATIONS**

The value added tax (VAT) has been an instrument of choice for most developing countries which contemplated reform of their sales taxes.

We have observed in this paper that value added tax is a tax imposed on value added by firms on the inputs purchased by them. Value added is a difference between inputs of the firm and its output. Furthermore the mechanism of VAT shows that, value added taxation is a comprehensive method of taxing and collecting a general sales tax from final consumers of both domestically produced and imported goods, and services by instalments.

We have also noticed that there are three types of VAT namely the consumption type, the income type and the gross product type. Our consideration of a sample of eighteen developing countries has revealed that all countries except

Brazil have a consumption type VAT levied on destination basis. This type of VAT does not have distortions inherent in the other two types (see section 2.2).

Experience of many developing countries show that a comprehensive retail VAT is preferable to pre-retail VAT. However, in a case of very small traders there is a need for special schemes such as exempting them from registration as taxpayers or the use of presumptive assessment techniques. The VAT base of these countries includes both goods and services. Certain services are difficult to tax as such the best solution is to exempt them from VAT. Zero-rating such services would require registration of institutions rendering them and this would give rise to administrative complications. The differentiated rate structure should be avoided in order to minimise both administrative and compliance costs. A single rate would enhance efficiency, though it is inequitable. For the purposes of equity and efficiency essential goods should be zero-rated and excise duty should be imposed on luxury and traditional excise goods. This measure would create progressivity and more revenue would be collected.

We make the following recommendations for the design of VAT in Tanzania:

- Tanzania should contemplate a comprehensive VAT that extends through the retail stage. In order to enhance neutrality a consumption type VAT on the basis of destination principle should be considered.
- The VAT base should include both goods and services. Services must be taxed on the basis of integrated approach. Difficult to tax services should be exempt from tax.
- A zero-rate can be applied on essential goods primarily unprocessed foodstuffs and exports, and a single (uniform) rate on other goods. For the purposes of increasing revenue and income distribution excise duty should be imposed on luxury goods; alcohol,

tobacco, cigarettes and spirits.

- An adequate period of preparation and publicity is essential. Education programmes and campaigns should be established so as to enable tax officials, tax payers and the public in general to understand the concept and mechanism of VAT. Indeed, VAT would gain acceptance and encourage voluntary compliance, hence, the government would be able to collect maximum revenue.
- VAT computerisation is of significant importance since taxpayers under VAT will be more compared to the number of taxpayers under the current sales tax system. This would minimise administrative costs.

#### END NOTES:

1. *For example in 1975 UK had ten and twenty five different rates respectively, which were levied on personal earned income. The highest rate in the UK was 83% and 70% in the US. In 1990-1991 the rate brackets were reduced to only two in both countries and the top rate reduced to 40% in the UK and 33% in the US (see Kay and King, 1990; and Wilkinson, 1992).*
2. *The term commodity includes service which can be defined as any commodity that is not good (see Cnossen, 1994: 73).*
3. *For a detailed discussion see Sullivan, 1965; NEDO, 1968; Mclure, 1987 and Guerard, 1973.*
4. *Under the current sales tax system in Tanzania, delivery of goods for own consumption is chargeable to tax. (see section 2(1) of the Sales Tax Act 1976).*
5. *For detailed discussion and findings see Sandford, C.T., Godwin, M., Hardwick, P., and Butterworth, M., (1981); Sandford, C.T., Godwin, M. and Hardwick, P. (1989), and Tait 1988.*

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