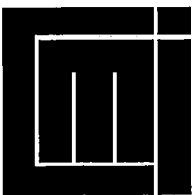


# Value-Added Taxation in Tanzania?

Odd-Helge Fjeldstad

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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:**

Value added tax  
Taxation  
Tax reforms  
Tanzania

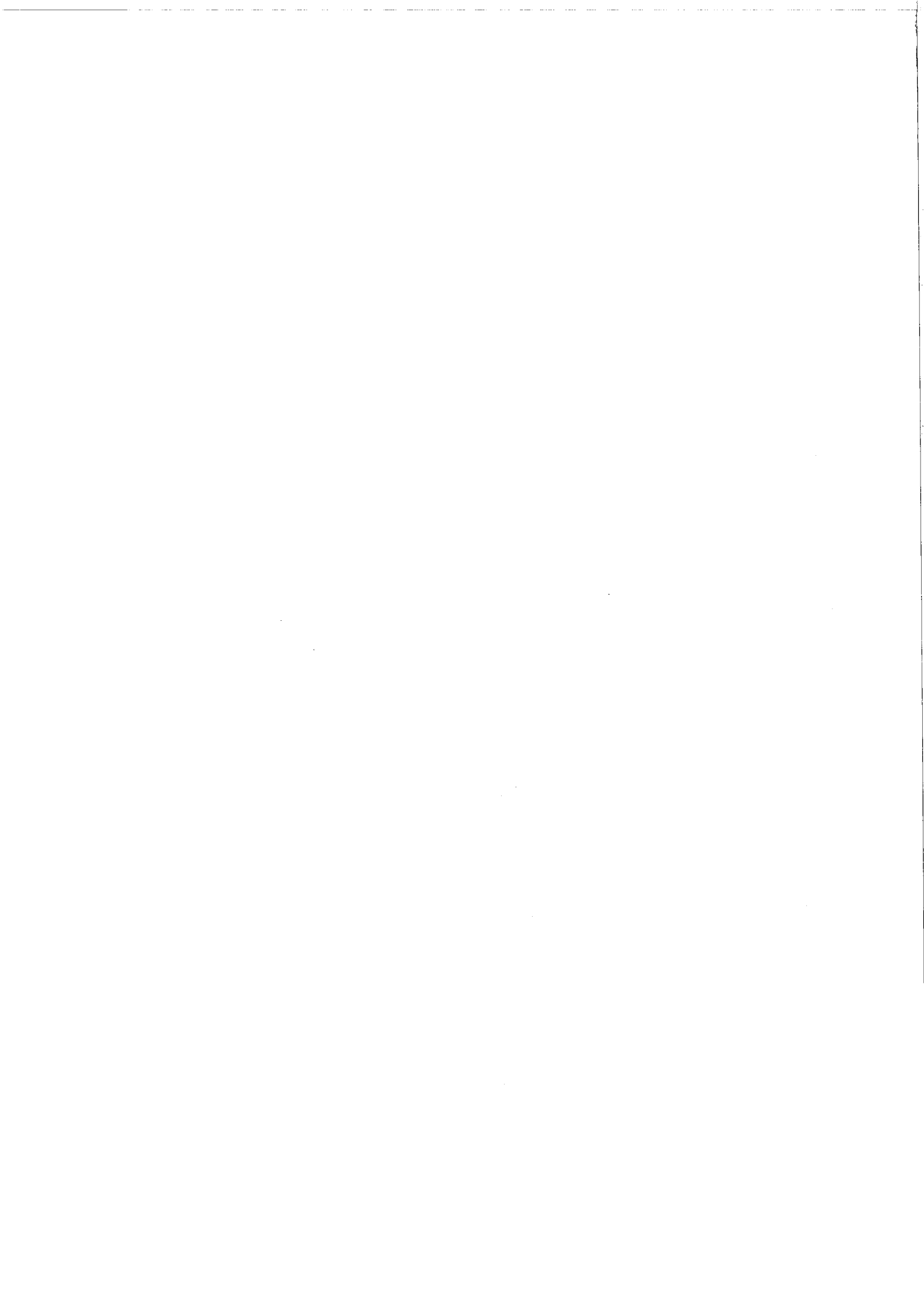
### **Stikkord:**

Merverdiavgift  
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## 1 Introduction and overview<sup>1</sup>

In December 1991 the Tax Commission, appointed by the Government of Tanzania, offered a proposal for reform of the Tanzanian tax system.<sup>2</sup> 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.<sup>3</sup>

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

<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> 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.<sup>4</sup>

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).

<sup>4</sup> 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:<sup>5</sup>

- 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

<sup>5</sup> 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.<sup>6</sup> 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.

<sup>6</sup> This point is, however, questionable (see section 3.4 and 4.2).

### 2.3 *Alternative types of VAT*<sup>7</sup>

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:

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

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):

$$\text{GNI} = V + D$$

The basic national accounting identity is given by:

$$\text{GDP} = \text{GNI}$$

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

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

<sup>7</sup> 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:

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

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:

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

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.<sup>8</sup> 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.<sup>9</sup>

<sup>8</sup> This distinction is analogous to that between the residence and source principles in income taxation.

<sup>9</sup> 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*.<sup>10</sup>

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).<sup>11</sup>

<sup>10</sup> 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.

<sup>11</sup> 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.<sup>12</sup> 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.

<sup>12</sup> 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
<i>Tanzania</i> (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.<sup>13</sup> 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.<sup>14</sup>

<sup>13</sup> This is also the case in Tanzania (URT, 1991b; and Bagachwa and Naho, 1995).

<sup>14</sup> 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.<sup>15</sup> 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

<sup>15</sup> 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.<sup>16</sup> 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.

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

