# Taxation and Tax Reforms in Tanzania: A Survey

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**Summary:**
This paper reviews the tax system in Tanzania, and gives particular attention to the tax reform proposals presented in the Report of the Presidential Commission on Taxation. In considering the effects of the "low-rate, broad-base" tax reform strategy that has been adopted, it is argued that there are major shortcomings in the implementation of the tax reform. This particularly relates to the continuous and widespread tax evasion, extensive tax exemptions and inefficient tax administration. The discussion in this paper reinforces the arguments for improving the quantitative analysis of revenue policy, and taking more specific and focused measures to improve tax administration.

**Sammendrag:**
Dette notatet tar utgangspunkt i den pågående skattereformen i Tanzania. Sentrale elementer i reformforslaget har ikke blitt implementert. Spesielt gjelder dette tiltak for å utvide skattebasen. Betydningen av mer fokuserte tiltak for å forbedre skatteadministrasjonen, med sikte på å begrense den omfattende skatteunndragelsen og utstrakte bruken av skattefritak, blir drøftet.

| **Indexing terms:** | **Stikkord:** |
|---|---|
| Taxation | Skattlegging |
| Tax reforms | Skattereformer |
| Tanzania | Tanzania |

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# 1 Introduction and overview[1]

Since the adoption of the World Bank/IMF supported Economic Recovery Program (ERP) in 1986, the Government of Tanzania has undertaken various policy reform measures, including trade and exchange rate reforms, banking and financial sector reforms, and reforms in agricultural marketing. It has also embarked upon a comprehensive tax reform process. While piecemeal reforms of particular taxes have been going on since the late 1960s, the Government appointed a "Commission of Enquiry into Public Revenues, Taxation and Expenditure" in October 1989 to study and review the central and local government tax systems and its administration, and make recommendations.[2]

In December 1991, the Tax Commission offered a proposal for reform of the Tanzanian tax system. The proposal shares several features with reforms that have taken place or are to be implemented in other countries since the mid-1980s (Fjeldstad, 1995a). The Commission recommended reducing the marginal tax rates on personal and company income, to broadening the tax base by eliminating exemptions and to introduce more efficient enforcement mechanisms, to introduce measures to simplify the tax system, and, more controversial, to introduce a value-added tax.[3]

There are several reasons why the Tanzanian case is worth studying. First, both internal and external economic and political conditions have changed significantly during the last decade, with huge effects on both public revenue and expenditure structures (Mans, 1994, World Bank, 1994a). Second, the Economic Recovery Programme (ERP) provides a broad outline of politics, including measures to increase revenue and reduce the growth of public expenditures. Fiscal reforms have, thus, come to the heart of the ongoing economic and political reforms (URT, 1991a; World Bank, 1994a and 1995b). Third, extensive tax evasion and avoidance, reflecting poor compliance and poor administrative capacity as well as other institutional constraints, have important impacts on the design and implementation of tax reforms (Bird, 1992; Tanzi, 1991; and Tanzi and Shome, 1993). Because Tanzania has much in common in these respects with other low

[1] This paper is based on a study commissioned by the Macro Group in Dar es Salaam, whose members are drawn from the National Planning Commission, Ministry of Finance, Bureau of Statistics and Bank of Tanzania. I have benefited greatly from discussions with members of the Macro Group and I wish to express my heartfelt thanks for their hospitality and support. I would also like to thank Arild Angelsen, Ibrahim Lipumba, Hildegunn Nordås and Ussif Rashid Sumaila for many helpful comments on an earlier draft of this paper, and to the Norwegian Agency for Development Co-operation (NORAD) and the Norwegian Research Council for financial support. Opinions are entirely mine.

[2] Here I refer to this as the Tax Commission or the Commission (URT, 1991a).

[3] The proposal of introducing a value-added tax in Tanzania, is discussed in Fjeldstad (1995b).

income countries, especially in Sub-Saharan Africa, its experiences may provide valuable information about the appropriate design and reform of tax systems.

This paper begins by reviewing the background to the 1991 tax reform proposal, and considers in section 2 two types of factors of particular relevance in this respect: the structure of taxation, and the more fundamental characteristics of the Tanzanian economy which may in part explain the present structure of taxation. The focus in section 3 is on the objectives and features of the 1991 tax reform proposals. In considering the effects of the adopted "low-rate, broad-base" strategy, I argue that there have been major shortcomings in the measures recommended to widen the tax base. Section 4 proceeds by asking which factors could explain the significant drop in tax revenues experienced after the implementation of reform proposals in fiscal year (FY) 1992/93. I put forward and discuss four factors which are of particular importance in this respect: (i) reduced tax rates; (ii) extensive tax exemptions; (iii) widespread tax evasion; and (iv) inefficient tax administration. The aim of section 5 is to discuss the revenue productivity of the Tanzanian tax system in relation to the Government's objective of fiscal self-reliance. I question the realism of this objective when only focusing on the revenue side of the budget, and argue that there are grounds to believe that a major budgetary problem in Tanzania is the level of public expenditures. Finally, in section 6 I evaluate some of the policy implications, particularly for the present tax system.

## 2 The tax system in Tanzania

The tax system found in any country and the potential changes that may be made in the system inevitably reflects the economic structure of that country. Before engaging in a detailed analysis of tax policy it is therefore important to consider some fundamental characteristics of the Tanzanian economy which may in part explain the present structure of taxation. In this section I put forward and discuss four factors which are of particular importance in this respect:

1. Income per capita and income distribution.
2. The agriculture sector.
3. The formal and informal sectors.
4. The public sector.

### *2.1 Background for tax reform*

*1. Income per capita and income distribution.*

Tanzania is one of the poorest countries in the world, with a population of roughly 28 million, growing at 3 percent per year, and covering the eight largest land area (945,000 square km) in Sub-Saharan Africa (World Bank, 1995b). Per capita income was estimated to USD 90 in 1993, and average annual GNP growth per capita during the period 1980-1993 was estimated to 0.1 percent (World Bank, 1995a).[4] Poverty is widespread with about half the population below the poverty line (Ferreira, 1993).[5] Income distribution is distorted. In 1991, the highest 10 percent fractile of persons, ranked by per capita expenditures, received more than 45 percent of national income, and the lowest 20 percent fractile received roughly 2.5 percent (Mans, 1994). Thus, the scope for extensive reliance on personal income taxation is limited. While, in principle, the rich could have paid a high level of tax on income, the necessary administrative apparatus required for enforcement and collection does probably not exist, and if it did, would probably not be cost efficient. Moreover, economic distortions are likely to arise if very high income tax rates were imposed.

*2. The agriculture sector.*
The majority of the population is engaged in agriculture, largely subsistence agriculture. Nearly 80 percent of the total population live in rural areas (1992), and 85 percent of the labour force is engaged in agriculture (1990-92).[6] Agriculture accounts for about 50 percent of GDP (1991-93),[7] with nearly four fifths of the activity in the small holder sector. It also accounts for nearly 70 percent of total export earnings (1992 and 1993). Transactions within this sector are, however, generally hard to observe and therefore hard to tax (Newbery, 1987:202). The probably only easy way to tax small-scale farmers is through export taxes, and substantial revenue used to accrue to the government by way of taxes on export produce. In 1976/77, export taxes contributed nearly 16 percent of total tax revenue. In 1979/80 this percentage was about 6 percent. This reduction was mainly caused by poor export performance and heavy disincentives to export production resulting from overvalued exchange rates, weak and expensive marketing and transport systems.[8] Later, in order to encourage exports, it was decided to reduce the number of export goods subject to taxes. Finally, in 1985/86, all export taxes were removed.

4 In Human Development Report 1995 (UNDP, 1995) real GDP per capita in 1992 is estimated to USD 620 (PPP).

5 The poverty and hard core poverty lines have recently been estimated at TSh 46,173 and TSh 31,000 respectively (Ferreira, 1993). Poverty is particular pervasive in rural areas. 59 percent of village households are poor, and 90 percent of hardcore poverty is in rural areas (Mans, 1994:408). See World Bank (1990) for a discussion of measures and characteristics of poverty.

6 Figures from World Bank (1995a). See World Bank (1994b) for a more detailed presentation of the agricultural sector in Tanzania.

7 The figure is in current prices (Bank of Tanzania, 1993:14), and varies slightly with other sources. According to the World Development Report 1995, agriculture contributed to 56 percent of GDP in 1993 (World Bank, 1995a).

8 See Havnevik et al. (1988), and URT (1991a:para 3.8 ).

*3. The formal and informal sectors.*
There is a relatively small "formal" sector in Tanzania. In the non-agricultural sectors,which accounts for the other half of GDP, the formal sector employs only a minor part of the labour force. Recent estimates suggest that recorded non-agricultural employment is 5 to 6 percent of the adult population (World Bank, 1992:2). Within the formal sector, the largest single employer is the Government. As in the case of small-scale and subsistence farming, it is, in general, difficult to tax small retail establishments, self-employed businessmen, professionals and petty traders (Musgrave, 1987 and 1990). At least four major problems arise in taxing these so-called hard-to-tax groups. First, the need to deal with a large number of taxpayers may result in heavy administrative costs, which may ultimately be larger than the amounts of revenue actually collected (Musgrave, 1990:299). Second, administration is difficult because many of these taxpayers, especially the farmers and the small businesses, may find it burdensome to maintain books of account. Third, even if such books are kept, the tax officials have little evidence by which to judge their accuracy. Finally, taxation may result in taxpayers withdrawing from the market, for instance, farmers may go into subsistence farming when their output are taxed (Hyden, 1980).

These problems are particularly severe in Tanzania because the informal sector appears to have been growing particularly rapidly. According to Bagachwa and Naho (1995) the second economy in Tanzania "seem to have grown from a low level of less than 10% of official GDP during the late 1960s to a sizeable proportion of over 20% after the mid-1980s".[9] Unrecorded activities in areas such as construction, real estate, repair workshops, transport, etc. generate sizeable incomes, but because of administrative difficulties these income sources remain untapped for tax purposes. According to Ferreira (1993), income from informal sector business and agricultural activities contributed 44 and 34 percent of total income of urban households, respectively. In Dar es Salaam the respective figures were 83 and 1 percent.

*4. The public sector.*
The public sector in Tanzania is large and accounts for the main part of non-agricultural formal sector activity. Employees of government and parastatals account for at least 75 percent of total number of employees in the formal sector. Of these nearly one third are employed in parastatals (World Bank, 1992). In 1993, the civil service (exclusive parastatal employees) consisted of nearly 350,000

[9] These figures should be considered with caution. In an earlier study, Bagachwa and Naho (1993:19) estimate the second economy to more than 40 percent of GDP. The discrepancy between these studies reflect the uncertainty related to such estimates (see also Maliyamkono and Bagachwa, 1990). The definition of the "second economy" used by Bagachwa and Naho (1993 and 1995) is close to that of the "underground" economy used by, e.g., Tanzi (1983). Thomas (1992) provides a thorough discussion of definitions and characteristics of informal economic activity.

civil servants (World Bank, 1994a). The entire structure of wages for civil servants is fixed unilaterally by the Government. During the 1970s and 1980s, there has been a severe erosion in the real wages and salaries of civil servants. Average salaries in the late 1980s, for example, provided only one-fifth the purchasing power of the 1970s. The Government also controls the wages of parastatal employees, although the electric power authority has introduced a performance-based pay scheme. Other profitable parastatals are also proposing to increase wages substantially.

Civil servants also receive monetary allowances of, on average, 35 percent of wage remuneration. Allowances differ significantly between the different categories of civil servants. The upper ranks of the civil service, for instance, also enjoys several in kind benefits, such as free housing, telephone, and transport. The abundance of allowances has contributed to a remuneration structure that is non-transparent and inequitable (World Bank, 1994a:v). According to Mans (1994:378), the average civil servant's package of wages and monetary allowances covers only about 40 percent of the expenses of a typical household.

With somewhere close to 350 parastatals, distributed across all sectors of the economy, Tanzania has one of the largest parastatal sector in Sub-Saharan Africa.[10] About 275 of these are commercial parastatals that play a dominant, often monopolistic, role in many key sectors. Manufacturing parastatals account for about 60 percent of total value added in the sector and they have monopolies in several major segments of the industrial sector, e.g., production of beer, cigarettes, steel and electric cables. The state also enjoys a dominant position in the services sector, including the hotel sector (Mans, 1994:378-380).

In general, the financial performance of the parastatals is poor. According to the government auditor of parastatal accounts (Tanzania Audit Corporation), net losses after taxes before interest payments for commercial parastatals were about 8 percent of GDP in fiscal 1989 (Mans, 1994:380). Recent studies show that more than 50 percent of parastatals are inviable and require subsidies to continue operating. The chronic loss-makers avoid paying taxes and pension funds contributions, as well as the counterpart fund share of the commodity import support funds they receive.

Restructuring of parastatals is commenced as a part of the economic recovery programme (ERP). By mid 1994 there had been 20 divestitures and a further 22

[10] Hyden (1983:96) argues that the expansion of the parastatal sector since independence can be explained with reference to two interrelated factors: First, by a strong desire by the government to establish control of the national economy by buying out foreign capital, and, second, by the absence of strong pressures from an indigenous capitalist class for expansion of the private sector. A combination of these factors paved the way for an almost inordinate expansion of parastatals in Tanzania, as well as in several other African countries.

enterprises had been liquidated or closed, while 117 parastatals were in the initial stages of preparing their restructuring plans (URT, 1994:13-14). However, several factors impede the pace of the privatization. The Government is still reluctant to sell the few profitable parastatals. Further, in the absence of a social safety net for workers who would be released, the Government is reluctant to undertake the more extensive liquidations that may be inevitable (Mans, 1994:381). This is also the case with the civil service retrenchment programme initiated in 1992/93, where a key element was the retrenchment of 50,000 civil servants over a three year period. Under this programme, while some categories of civil servants identified to be redundant are being retrenched, other categories, especially personnel in education, health and security, which account for almost 50 percent of the civil service, continue to be hired (World Bank, 1994a:v). In the short term, one may expect that the retrenchment of civil servants and privatisation of parastatals will imply some negative budgetary impacts on tax revenue.

## 2.2 *The structure of the tax system*

The tax structure and its changes over the last 15 years are shown in Table 2.1 and 2.2. The composition of taxes has fluctuated much since fiscal year (FY) 1989/90. In FY 1991/92, for instance, there was a considerable drop in direct tax revenues (on income and wealth), mainly caused by reduced revenues from company taxes. In FY 1992/93 there was a significant drop in revenues from indirect taxes, on both domestic goods and services and international transactions, partly caused by reduced tax rates introduced as part of the ongoing tax reforms (see section 4.1).

It is conventional to distinguish direct from indirect taxation. The *Concise Oxford Dictionary of Current English* (Sykes, 1984) defines an indirect tax as one "paid by consumer in form of increased price for taxed goods". The dictionary defines a direct tax as one "levied on persons who bears the ultimate burden of tax, e.g. income tax, but not value added (tax)". In a world in which the incidence of taxation is an issue of complexity (Atkinson and Stiglitz, 1980; and Mclure, 1990), such definitions are difficult to sustain. In general, the distinction between direct and indirect taxes reflects at least three different aspects of tax structures (Kay, 1990): (1) The choice between taxes on income and taxes on consumption; (2) the choice between taxes on commodities and taxes on individuals; and (3) the choice between a source of origin and a destination basis for taxation. Without elaborating these distinctions any further, I here follow the categorization of taxes used by the Tanzanian Treasury.

Table 2.1

Structure of central government taxation, 1979-95 (in percent of total taxes)

| | 1979/80 | 1984/85 | 1989/90 | 1991/92 | 1992/93 | 1993/94 | 1994/95 |
|---|---|---|---|---|---|---|---|
| **Taxes on income and wealth** | **36.2** | **29.1** | **27.8** | **18.8** | **31.0** | **26.5** | **26.6** |
| PAYE | 10.3 | 9.0 | 4.3 | 3.2 | | | |
| Individuals | 2.4 | 2.4 | 2.0 | 1.9 | | | |
| Companies | 21.6 | 15.7 | 19.0 | 13.7 | | | |
| Other | 1.9 | 2.0 | 2.5 | | | | |
| **Taxes on domestic goods and services** | **41.8** | **54.5** | **44.0** | **40.9** | **31.5** | **31.9** | **33.1** |
| Sales and excise tax - local | 40.2 | 51.2 | 37.4 | 40.9 | | | |
| Other | 1.6 | 3.3 | 6.6 | | | | |
| **Taxes on international transactions** | **22.0** | **16.4** | **28.2** | **28.7** | **21.6** | **22.8** | **24.0** |
| Import duties | 11.9 | 8.8 | 14.3 | 14.8 | 10.8 | | |
| Sales and excise tax - imports | 3.0 | 7.4 | 13.7 | 13.9 | 10.8 | | |
| Other | 7.1 | 0.2 | 0.2 | | | | |
| **Other taxes*** | | | | **11.6** | **15.9** | **18.7** | **16.3** |

* Other taxes consist of motor vehicle taxes (35% in 1991), misc. taxes (63% in 1991) and property taxes (2% in 1991).

Sources: URT (1992d); URT (various years): Flash reports; and URT (various years): Budget frame projections.

Table 2.2
Central government revenue and expenditure, 1985-95 (in percent of GDP)

| | 1985/86 | 1986/87 | 1987/88 | 1988/89 | 1989/90 | 1990/91 | 1991/92 | 1992/93 | 1993/94 | 1994/95 |
|---|---|---|---|---|---|---|---|---|---|---|
| Taxes on income and wealth | 4.5 | 3.8 | 4.3 | 6.7 | 4.8 | 3.6 | 3.9 | 3.6 | 3.6 | 3.5 |
| Sales and excise taxes | 7.7 | 8.7 | 8.4 | 9.1 | 9.1 | 10.4 | 11.4 | 3.6 | 4.4 | 4.4 |
| Import duties | 1.1 | 2.1 | 2.0 | 2.3 | 2.5 | 2.6 | 3.1 | 2.5 | 3.1 | 3.2 |
| Other taxes* | 0.7 | 0.8 | 1.6 | 1.7 | 1.8 | 1.5 | 2.4 | 1.8 | 2.6 | 2.2 |
| **Tax revenues** | **14** | **15.4** | **16.3** | **19.8** | **18.2** | **18.1** | **20.8** | **11.5** | **13.6** | **13.3** |
| **Nontax revenue*** | **0.7** | **0.9** | **1.7** | **1.8** | **1.8** | **1.6** | **2.7** | **1.4** | **1.4** | **1.2** |
| **Current revenue** | **14.7** | **16.3** | **17.1** | **21.6** | **19.9** | **19.7** | **23.5** | **12.9** | **15.0** | **14.5** |
| **Total expenditures** | **23.1** | **27.1** | **25.3** | **28.7** | **26.7** | **35.3** | **26.4** | **26.7** | **25.4** | **19.5** |
| **Deficit before grants** | **(8.4)** | **(10.8)** | **(8.2)** | **(7.1)** | **(6.6)** | **(15.6)** | **(2.9)** | **(13.8)** | **(10.4)** | **(5.0)** |
| **Deficit after grants** | | | | | | | | **(8.3)** | **(5.7)** | **(3.1)** |

* Figures for 1985/86-1990/91 are estimated as 50% of "other taxes and nontax revenues" from table B7 in URT (1992a).

Sources: URT (1992a); URT (various years): Flash reports; and URT (various years): Budget frame projections.

*Indirect taxes.*
Taxes on goods and services, including sales and excise taxes on imports, are the largest single source of tax revenues in Tanzania, accounting for about 55 percent of total tax revenue and more than 11 percent of GDP in 1991/92, and about 40 percent and almost 4 percent in 1992/93, respectively. In the two last fiscal years the percentages have been somewhat higher than 40 percent and 4 percent, respectively (see Tables 2.1 and 2.2). Sales and excise taxes are lumped together in the tables, both for comparability over time and because the introduction of the widespread excise system in 1989 was more a change in form than in reality (see section 3.1). In effect, all that happened was that goods subject to sales tax rates of 50 percent or more became subjected to excise taxes at similar levels. Sales and excise taxes are, at present, for the most part, levied on the same narrow base of manufactured products.

The structure of excise duty rates, prior to the 1992/93 budget announcement, was quite complex. Both *ad valorem rates* (10, 20, 25, 35, 50, 60, 80 and 85 percent) and *specific rates* as well as composite rates for some items were levied. The base of excise duty was very wide with coverage extending to several hundred items, with the major revenue coming from duties on the "traditional" excise products - beer, cigarettes, spirits, soft drinks and petroleum. In the 1992/93 budget, all ad valorem rates barring 20 percent were abolished, and commodities which were being charged less than 20 percent were exempted from excise. The base was further narrowed by removing excise duties on locally produced goods such as sugar, soap, textiles, matches etc..

The rate structure of sales tax has also gone through major changes since 1991. Both the number and the magnitude of sales tax rates have been reduced (see section 3.3). Currently, the rates on scheduled articles (both domestically produced and imported) are: zero rate (for some raw materials and capital goods), 20, 30 and 40 percent, the latter being charged on "luxury" items. The sales tax on beer, cigarettes, petroleum, soft drinks, and spirits also contributes to a considerable part of these revenues. Services (catering services in designated hotels and restaurants, telephone and electricity) are charged at 5, 10 and 15 percent.

While the main source of tax revenue continues to be taxes on goods and services, the share of taxes collected at the border first fell in the early 1980s and then rose substantially in the latter half of the decade (Table 2.1 and Figure 2.1), reflecting both increased tax rates and the expansion of imports accompanying the early phase of the Economic Recovery Programme (ERP). The abolition of export taxes in 1985/86 (included in "other taxes on international transactions") was more than compensated for by the considerable growth of sales and excise taxes levied on imports. In fact, all of the growth in sales and excise taxes over this period is accounted for by taxes on imports. In 1992/93, however, there was a significant drop in revenues from taxes on international transactions, partly due to reduced rates. This was also the case for indirect taxes on domestic goods and services (see section 4). During FY 1993/94 and 1994/95 tax revenues from these bases have stayed almost at the 1992/93 level relative to total tax revenues and GDP.

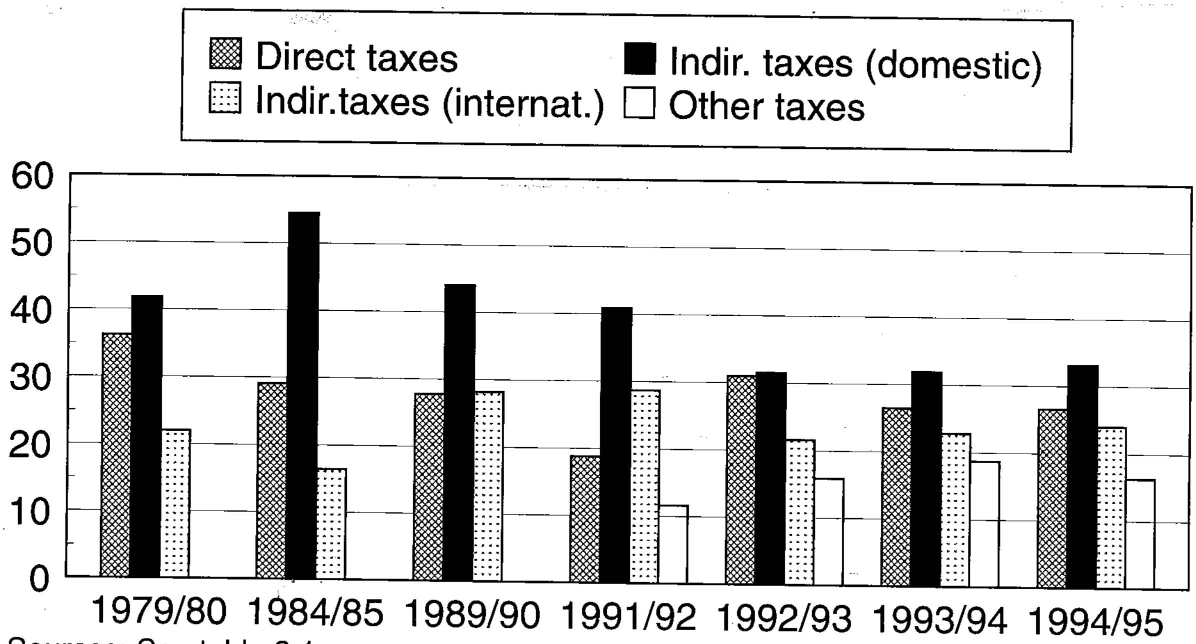
*Direct taxes.*
The following facts emerge from Tables 2.1 and 2.2:

- By far the biggest source of income tax revenue is the company income tax. Two thirds of total income tax revenue in fiscal 1991/92 came from tax on private companies and parastatals.
- Most personal income taxes are collected from PAYE (pay-as-you-earn).[11] The importance of this source of revenue has, however, declined over the last decade - from 31 percent of total income tax revenues in 1984/85, to approximately 17 percent in 1991/92. The relative decline of PAYE reflects equity considerations in the face of declining real earnings. For example, average salaries of civil servants in the late 1980s provided only one-fifth the purchasing power of the 1970s (see section 2.1). Since personal income tax bands are not indexed, the tax rates were reduced each year in the late 1980s (Basu and Morrissey, 1993:17).
- Taxes on wealth (land rent and estate tax) are not important sources of revenue any further.
- Since 1992/93, income taxes have increased their relative importance and now constitutes approximately the same share of total tax revenue (about 25 percent), and GDP (above 3 percent), as taxes on international transactions.

Equally important, but not obvious from Table 2.1, is the importance of the public sector as a source of direct tax revenues. Approximately one third of direct tax revenues (taxes on income and wealth) came from taxes on parastatal profits in the early 1990s. Similarly, public sector employees (government and parastatals) accounted for nearly 75 percent of the PAYE tax base, and government employees alone contributed to nearly half of total PAYE collections.

[11] Pay-as-you-earn (PAYE) is a "third party" technique, which charge a third party, usually the employer, with the tasks of deducting the tax from the payment (wages and salaries) made to the taxpayer (employee), and remitting the proceeds to the government (Bird, 1983). Ideally, the tax withheld should equal the tax due (Bird, 1992:101). Experience indicates that tax evasion is minimized whenever there is withholding at source (Tanzi and Shome, 1993:816). In most low income countries the personal income tax system encompasses only a relatively small part of the potential tax base, in general, the public and parastatal sectors employees where withholding systems may function (Bird, 1992).

Figure 2.1
Structure of central government taxation, 1979-95
(in percent of total taxes)



Sources: See table 2.1

To sum up, Tanzania's tax base by the mid 1990s appears to rest on three sources. The first is the "traditional" excise and sales tax base of the so-called "demerit goods", i.e. beer, tobacco, spirits and so on. The second source is taxes on imports, particularly consumer goods imports, and the third is taxes on company (including parastatal) profits and civil servant salaries. Since the economic recovery programme is focused very much on adjustments in both trade policy (e.g., through reduction in tariffs), and in the size and scope of public sector activity (e.g., through retrenchment of civil servants), these tax sources are rather precarious. It is therefore important to restructure the revenue system both to accommodate these adjustments as well as to cope more adequately with the severe underlying fiscal imbalances (see section 5).

## 3 Tax reforms in Tanzania

The tax reform initiatives in Tanzania may partly be considered as a response to the threatening of a major fiscal crisis. This is reflected in the fact that most of the proposed and implemented tax reforms in Tanzania have been guided by the need to increase revenues. Before discussing the Tax Commission's proposals in more detail, I will briefly summarize the major issues dealt with in previous tax reforms in Tanzania.

## *3.1 A brief history of tax reforms in Tanzania*

Substantial efforts have already been made to improve taxation in Tanzania. Since 1969 there has been several tax reforms which have included (Osoro, 1992a:413):

- Introduction of sales tax in 1969.
- New income tax legislation in 1973.
- Amendment of the existing tax legislation to revise the tax bases and rates.
- Abolition of some excise duty in 1979 and export duty in 1985/86.
- Re-introduction of previously abolished excise duty in 1989.

In recognition of the continued poor functioning of the tax system and the need to look at the tax system as a whole, the Government appointed a Tax Commission in October 1989. The Commission's primary task was to study and review the central and local government tax system and its administration, and make recommendations to the government. Specifically, it was to recommend changes to the existing tax system to:

- widen the tax base;
- enhance revenue collections; and
- promote greater efficiency of production in the economy.

The Commission's report was presented to the Government in December 1991 (URT, 1991a).

## *3.2 The Tax Commission's recommendations*

An important goal established by the Tax Commission was to increase the degree of Tanzania's "fiscal self-reliance" in terms of achieving a surplus in the recurrent budget instead of the significant deficit of recent year (URT, 1991a:para 2.19)[12].The Commission's principal proposals for tax structure reform can be summarized to:

*Direct taxes*
- Broaden the tax base by taxing fringe benefits and improving compliance, aided by more effective enforcement.
- Further reduce the tax rates on individual and company income, but apply these rates on a broadened base.
- Make some adjustments for the effects of inflation.

[12] See also section 5.

*Indirect taxes*

- Replace the current multiple-rate structure of sales and excise taxes by a value-added-tax (VAT) and a limited number of excises on traditional excisable goods and luxury items.
- Simplify the customs duties by reducing the number of rates, and reducing exemptions from both customs and sales taxes.

This "low-rate, broad-base" strategy was considered to be more consistent in practice with both efficient resource allocation and equity than the "high-rate, narrow-base" pattern that had dominated the Tanzanian tax system in the past (World Bank, 1992). These proposals also shared many features with the tax reforms in other countries since the 1986 US tax reform (Fjeldstad, 1995a). In this section I discuss in more detail some of the Commission's proposals:

*Personal income taxes*

The essential problem with the personal income tax in Tanzania is the low tax base, inherently because so many people are on low incomes.[13] In addition, little income is actually taxed (Basu and Morrissey, 1993:21). Probably the most important single recommendation made with respect to personal income tax was to bring "fringe-benefits" into the tax base (URT, 1991a:para. 6.42). The current remuneration system for civil servants consists of a meagre basic salary supplemented by a host of non-taxable monetary and non-monetary allowances. A very large fraction of the monetary compensation of many civil servants takes the form of non-taxable allowances (see section 2.1). The ratio of monetary allowance to salary for the 172 employees in top scale (SS2) in November 1991 was 530 percent. The average ratio for all ranges was 35 percent, indicating that an extra 35 percent of their monthly salary was given in the form of non-taxable monetary allowances. These figures would probably be even more striking if it was possible to obtain data on the many in-kind benefits received by senior officials and politicians. This practice has severely eroded the tax base, especially since the practice within the public sector has been adopted by the private sector. The Tax Commission strongly recommended to incorporate into the personal income tax base all monetary allowances and fringe benefits (e.g., responsibility allowance, house and transport allowances, etc.), and in kind personal benefits (e.g. car, home utility services). This recommendation is, however, inextricably connected with the reform of civil service pay schedules.

The Commission recommended the number of tax bands to be limited to about seven, the maximum marginal tax rate being 40 percent and the minimum rate should be set at 5 percent (applying to those earning above the minimum wage). At the appropriate time, consideration should be given to reducing the maximum

[13] Poverty is widespread with about half the population below the poverty line (see section 2.1).

40 percent rate (URT, 1991a:executive summary para 15). Further, all employees within the PAYE system should be required to file a tax return (URT, 1991a:para 6.62). However, since the Income Tax Department, at present, is not able to deal adequately with the taxpayers who already file, it would be difficult to implement this recommendation unless the necessary administrative measures are taken first. What is required is probably more effective use by the Tax Authority of the information already available from the PAYE system and other sources.[14]

With respect to non-PAYE taxpayers, mainly the self-employed, the Commission recommended the use of "standard assessments" for those with turnover less than Tsh 10 million (URT, 1991a:para 6.79). Many developing countries have found this approach to be useful in dealing with the so-called "hard-to-tax" group, but experience suggests that considerable care is needed in developing and applying such "standard" (minimum) assessments.[15] Nonetheless, despite the difficulties, it seems essential that the Government begins to take some effective action to extend the reach of the tax system into the informal sector, and one way of doing so may be through a "standard assessment" system.

The Commission is clear that no additional revenue is to be expected from this source as a whole (URT, 1991a:executive summary, para 11). Most of the recommendations with respect to direct taxes would in fact appear to reduce revenue, with the major exception of the recommendation to tax fringe benefits and withdraw the tax exemptions given for housing allowances, responsibility allowances and diligence awards. It appears that losses can be avoided only if tax administration is substantially improved. There is certainly considerable room for such improvement, but experience suggests that there are much uncertainty attached to revenues from this source (World Bank, 1992). This is also reflected in the fact that no attempt has been made by the Commission to attach any revenue figures to these recommendations. In this respect, the 1992/93 budget estimates, which depended partly on increases in direct tax revenues from improved administration, was misleading (see section 4).

*Company income taxes*

Some changes to company taxes were recommended by the Commission, notably to encourage payment of dividends and allow for accelerated depreciation in situations with high levels of inflation. The official rate of inflation in Tanzania has averaged around 22 percent annually in recent years.[16] Such high rates of

[14] Recently, Tanzania Revenue Authority was established (the Act was signed on August 8 1995). The two existing tax departments, the Department of Income Tax and the Customs and Sales Tax Department, will, after a transitionary period, be shut down and their responsibilites transfered to the new authority.

[15] See, e.g., Musgrave (1990) and Bird (1992).

[16] The inflation rate rose to 35 percent in FY 1994/95 (URT, Budget frame projections).