Sector Study of the Effective Tax Burden

Tanzania

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<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>CIT</td>
<td>Corporate Income Tax</td>
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<tr>
<td>DFID</td>
<td>Department for International Development</td>
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<td>EAC</td>
<td>East Africa Community</td>
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<tr>
<td>EPZ</td>
<td>Economic Processing Zones</td>
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<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GOT</td>
<td>Government of Tanzania</td>
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<tr>
<td>M&amp;E</td>
<td>Machinery and Equipment</td>
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<tr>
<td>METR</td>
<td>Marginal Effective Tax Rate</td>
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<tr>
<td>MSSE</td>
<td>Micro and Small Scale Enterprises</td>
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<tr>
<td>RA</td>
<td>Revenue Authority</td>
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<td>SEZ</td>
<td>Special Economic Zones</td>
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<tr>
<td>TRA</td>
<td>Tanzania Revenue Authority</td>
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<tr>
<td>TSH</td>
<td>Tanzania Shilling (1 US$ = TSH 1221.5)</td>
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<tr>
<td>VAT</td>
<td>Value Added Tax</td>
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<td>ZRB</td>
<td>Zanzibar Revenue Board</td>
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This report forms part of a multi-country study of African revenue authorities FIAS are undertaking in collaboration with the United Kingdom Department for International Development (DFID). The purpose of the study series is to determine whether the tax policy and tax administration regimes are conducive to economic growth. A key focus is on the opportunities created by bringing informal firms into the tax net and appropriate tax policies for small enterprises. FIAS undertook a pilot study in Zambia, published in December 2004.¹

On behalf of the Government of Tanzania, the Ministry of Finance, in conjunction with the Tanzania Revenue Authority, requested that FIAS conduct a similar study of the effective tax burden on five key sectors in the economy. The purpose was to investigate whether these sectors are competitive domestically and internationally, as regards the impact of the tax regime. This study provides the government with information it seeks through both quantitative and qualitative analysis. The quantitative analysis uses ‘marginal effective tax rate’ calculations carried out in each of the identified sectors. It also offers cross-country analysis allowing the assessment of international competitiveness. The qualitative analysis involves firm level interviews and secondary sources, by both political economy and sector experts. A third component built into this study is a capacity building exercise, with the group of international consultants tasked to work closely with a Ministry of Finance and Tanzania Revenue Authority counterpart group to transfer the knowledge and methodology underlying such an analysis.

¹ The Swedish Agency for International Development co-funded the Zambia study.
## Summary of Key Issues and Recommendations

<table>
<thead>
<tr>
<th>Issues</th>
<th>Recommendations</th>
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| **General Economy:** The income tax code and VAT legislation are broadly appropriate and conducive to growth of the five sectors. Tax policy issues are second order. Problems remain with implementation, the extent of exemptions, and local government taxation. | • Avoid significant changes to the tax code, which would create uncertainty in the private sector.  
• Enforce the ‘closed list’ of taxes available to local/municipal governments. Improve co-ordination and harmonization between national and local taxes. |
| **Agriculture Sector (METR 6%/23%):** Mostly informal and outside the tax net (bar local government cess levies of up to 5% on turnover, which are regressive). Incorporated agric. enterprises benefit from immediate capital expensing and VAT exempt inputs and outputs. | • Lower the cess ceiling to 3% to reduce the extent of urban bias.  
• Change the status of agricultural inputs and outputs from ‘exempt’ to zero-rated.  
• Remove all remaining agricultural export taxes. |
| **Mining Sector (METR 13%):** Individually negotiated ‘development agreements’ have provided generous relief. E.g. 0% duty on capital goods, 100% initial capital allowance. 3-5% royalties apply. | • Going forward, move toward a standard treatment of mining taxation. (i.e. no more individually negotiated agreements).  
• Apply the standard rate of depreciation for all new investments.  
• Abolish special relief in favor of VAT deferment. |
| **Manufacturing Sector (METR 15%):** 30% CIT, depreciation set at 50:25:25. EPZs offer further incentives. | • Secure sufficient funding to process VAT refunds within a month.  
• Consider offsetting VAT refund claims against other liabilities.  
• Separate 2% skills levy from development levy. |
| **Tourism (METR 15%):** 50% capital allowances. A number of incentives also apply for qualifying investments. Several industry specific levies and fees. | • Apply VAT to all tourism and transport services.  
• Investigate options for lowering VAT in the sector / economy.  
• Evenly apply the incentives offered across the whole sector. |
| **Financial Sector (METR 29%):** Competitive, but narrowly based bank sector. Small but growing equity market. All financial services are VAT exempt and imported capital inputs are VAT exempt. Pensions have a unique E/T/E tax system. | • Require financial services firms to pay VAT on capital inputs.  
• As part of on-going pension reform, move to a E/E/T system of taxation. Further competition in the pension sector should provide options for contributions lower than the current 10% / 10%.  
• Review and clarify taxation of capital leases for VAT. |
| **Small businesses (METR 29%):** Automatic presumptive regime for MSSEs with turnover < TSH 40m, based on a low turnover tax for MSSEs with records or a lump sum tax to MSSEs without. Although voluntary VAT registration is possible below the TSH 40m threshold, in practice most MSSEs do not register for VAT. As a result the METR for MSSEs can be as high as 50.5%. | • Simplify the presumptive regime.  
• Move from monthly to quarterly VAT returns; allow easier opt-in for VAT.  
• Enhance role of the TRA to include outreach and education for MSSEs, to explain the benefits of keeping records and/or registering for VAT. |
| **Institutional and Organizational:** TRA established in 1995, funding via the general budget. Multi-donor funded Technical Assistance Project (TAP) | • Over time, demarcate policy formulation and policy implementation.  
• Change the funding formula for the TRA, so that a proportion of its budget comes from a % of receipts collected.  
• Develop Taxpayer Charter into a legally binding agreement.  
• Reduce the number of organizations and activities that benefit from VAT and Customs exemptions. Specifically, remove donor funded projects from the exemption list. |
EXECUTIVE SUMMARY

Background

This FIAS/DFID report forms part of a series of studies designed to improve understanding of the impact of tax policy, and in particular its administration, on the business climate in Africa.

The establishment of semi-autonomous revenue authorities in various countries in the region has achieved one of its main aims, namely increased tax collection. There has been little focus on the possible business and growth impacts of revenue targets and internal performance incentives.

The study uses both quantitative and qualitative techniques to address these concerns. The quantitative component uses Marginal Effective Tax Rate (METR) techniques to investigate how the tax code, as defined in legislation, benefits certain sectors over others. The qualitative component addresses in more detail how tax administration works in practice, including a political economy analysis of the TRA as an institution.

Context of the Study

The Government is focused on tackling the structural problems of poverty reduction and is fully aware that strong growth, led by private sector investment, is a key to helping the Tanzanians improve their living conditions and make solid progress toward achieving the Millennium Development Goals. The recently published Poverty Reduction Strategy Paper (‘MKUKUTA’ in Kiswahili) acknowledges that enhanced efforts are needed to stimulate private-sector led growth, particularly in such areas as infrastructure, access to the financial sector, improving the business environment and governance.

Since 1993, the Government of Tanzania has made headway in its transition to a more market based economy. An important milestone in this process was the 1996 ‘Tanzania Investor Roadmap’. The Roadmap stated “While the current regulatory environment is difficult for medium and large scale formal sector firms, it is largely inappropriate and irrelevant to micro and small scale informal businesses.”
Tax revenue performance

From a macroeconomic perspective, tax policy in Tanzania has been increasingly effective at raising revenues, as measured by tax/GDP ratios. The current tax/GDP is 14.0% of GDP, up from 12.9% in 1996. However, this is still less than Kenya (22.7%) or Malawi (17.5%).

Main findings of the report

Tax Policy

This study concentrates on taxation whose burden falls on the corporate sector. The primary taxes are:

- Corporate income tax
- Value Added Tax (VAT)

In addition, companies may have to pay the following contributions during their operations, depending on the type of business:

- Customs duty
- Excise tax
- Withholding tax
- Capital gains tax
- Skills development levy

The results of this study provide input into the government’s tax policy discussions; it will allow the authorities to assess the relative tax and incentive packages in each of the key sectors of the economy and to determine the effectiveness of each package to investment and private sector development in the country as a whole. The primary finding however, is that tax policy in Tanzania is sound and not detrimental to investment and growth. The METR on capital is low for the region. In most circumstances issues other than taxation are businesses’ primary concern.

However, there are several issues which remain concerns for the private sector. These include: relatively high VAT of 20% (compared to a regional average of 16-18%); slow VAT refunds for exporters (while acknowledging that progress has been made on this issue over recent years); local taxes which can be a high proportion of profit, especially the cess taxes on agriculture; a lack of understanding, especially from small businesses, of their tax rights and responsibilities.

The proposed extension of Economic Processing Zones and Special Economic Zones in Tanzania could act as catalyst for increased investment. However,
learning from international experience, it is important that EPZs and SEZs focus on the provision of infrastructure and pilot areas for investment climate (including tax) reforms with streamlined business procedures and policies – rather than as vehicles for tax incentives.

**Tax Administration**

The impact of taxation on a business is a factor not just of the tax policy (tax instruments and rates) but also of the administrative burden they place on businesses. Small businesses especially, often find the costs of compliance as big an issue, if not more so, as the tax burden itself.

The Doing Business indicators² show that while Tanzania has a comparable number of taxes to the peer economies in the region (48 vs. 41), this is nearly three times the number of taxes paid in OECD countries. Tanzania performs better in terms of the time taken to complete tax forms with 248 hours, which is well below the regional average of 394 and not far above the OECD average of 197.

To mitigate the compliance costs of corporate tax, Tanzania has an innovative presumptive tax regime for small businesses (see Small Business Sector), based on four brackets of turnover. The system is flexible and allows small businesses the option to pay a flat payment if no records are kept, or a percentage of turnover plus a smaller flat payment if some records are kept. There are arguments both for and against presumptive regimes for small business such as this. VAT is often administratively difficult for small businesses, and continued efforts to make systems simpler would be of great benefit.

A significant administrative burden remains as a result of local taxes. In spite of recent years’ attempts to rationalize the local government revenue system, Local Government Authorities levy a large number of taxes, fees, licenses and charges. Lack of coordination between the central and local government levels leads to an increasing number of local taxes, which are difficult for taxpayers to understand.

**Sector analysis and recommendations**

**Agriculture**

Agriculture is the largest sector of the economy and accounts for 26% of formal GDP and an estimated 90% of the informal economic activity. The majority of

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² The World Bank’s Doing Business provides objective measures of business regulations and their enforcement across 155 economies. They indicate the regulatory costs of business and can be used to analyze specific regulations that enhance or constrain investment, productivity and growth. See <http://www.doingbusiness.org/>
farms are informal / subsistence and operate outside of the tax net, either because produce is not sold commercially or because the size of the business is so small. The exceptions to this are the farmers growing cash crops sold to traders. In these situations, ‘cess’ taxes are collected by local authorities (usually using traders as de facto tax collecting agents).

Ignoring the cess, the overall METR on capital for Agriculture is very low, at about 6%. This result primarily reflects the immediate write-off for machinery and equipment, which actually gives rise to a negative METR (and therefore a tax subsidy) when coupled with interest deductibility. Including 5% cess in the calculations increases the aggregate METR to over 23%. The cess is levied at different rates on different crops on agricultural turnover. As a gross turnover tax, with no deductions, the cess impinges quite significantly on the hurdle rate of return for a marginal investment.

**Recommendations**

- Tighten legislation governing local taxation to limit the ceiling on cess on ALL crops to 3% of farm gate price.
- Apply the Skills Development Levy (SDL) to agricultural firms.
- Change the VAT status of agricultural inputs from ‘exempt’ to ‘zero-rated’.
- Remove all remaining export taxes on agricultural products.

**Mining Sector**

The mining industry in Tanzania has recorded considerable growth over the past number of years, especially amongst large scale gold mining which has grown from a production of 323 kg of gold in 1997 to 46 219 kg in 2004, representing an increase of 29 550% in export value in 7 years.

In the past, through individually negotiated “development agreements” with the Minister of Minerals and Energy, a special mining license was awarded which effectively froze the fiscal regime at the point of the issue of the license for the entire period of the mining license, which is usually around 25 years.

These individually negotiated agreements differed depending on the timing of each agreement and were applicable to investors registered with the Tanzania Investment Centre (TIC). However, each was typically generous in terms of tax treatment. More recently there has been a move away from development agreements in Tanzania in favor of the general conditions offered in the tax law.
Royalties are charged at the netback value of minerals sold at the rate of 3% for gold and other minerals and at 5% for diamonds and other gemstones. A 0% royalty is applied to cut and polished gemstones.

*Ignoring royalties, the overall METR under the “old” regime is slightly negative suggesting a tax subsidy at the margin.* This is because of the immediate write-off of capital expenditures under this regime. Existing mines in Tanzania eligible for this treatment are able to continue to expense capital on mine expansions. *The “new” regime, for forthcoming mines, provides lower write-offs for capital equipment which increases the overall METR to around 13%.* Including royalties in the calculations increases the METR quite a bit, to 22% for the “old” regime and 32% for the “new” regime.

**Recommendations**

- Apply the standard depreciation rates applicable in the tax regime to the mining sector and eliminate the 100% initial allowance.
- Abolish special relief in favor of VAT deferment.
- Ensure that separate mining projects are ‘ring-fenced’.
- Remove the cap on fuel levies.
- Apply normal customs duties after the first year of production.

**Manufacturing**

The manufacturing sector in Tanzania has sustained high growth rates averaging 7% per annum in recent years, accounting for around 7% GDP and 10% of merchandise exports.

A Duty Drawback Scheme enables exporters to apply for refund of import duty paid on inputs used to produce exports. Export processing zones (EPZs) offer tax incentives to manufacturing firms producing primarily for export.

*The manufacturing sector faces an overall weighted average METR on capital of about 15%.* The 50% initial investment allowance generates a METR of just under 4% for machinery and equipment. This lowers the aggregate METR significantly because of the importance of equipment in the capital structure of manufacturers. Manufacturing firms are then able to write the balance of the capital expenditure off at a 25% declining balance rate, which is slightly higher than the economic depreciation rate for manufacturing equipment. This rate is
reasonable, however, given the lack of inflation indexing. Delays in VAT refunds can raise the METR to 26%.

**Recommendations**

- Increase transparency in VAT risk-profiling system by publishing criteria.
- TRA must secure sufficient funding to process VAT refunds in a more timely manner.
- Consider offsetting VAT refund claims against other tax liabilities.
- Separate SDL (2% of 6% charged) from development levy for increased transparency.
- Finance in-service rather than pre-employment training.
- Enable more systematic exchange of information between tax and customs agencies.
- Set up a specialist customs valuation unit.

**Tourism**

In 2005 Tanzania tourism industry is estimated to contribute 4.3% of GDP and generate 292,590 jobs. Corporate tax in the tourism industry is applied at the standard rate of 30%, but the industry benefits from generous initial capital allowances of 50% on plant and machinery used for providing services to tourists and plant and machinery fixed in a hotel or lodge.

The transportation of tourists by road and air are exempt from VAT, with the exception of taxi cabs and rental cars. Transportation by boat and the chartering of boats are not exempt and are subject to VAT at the standard rate.

The tourism industry benefits from a number of investment incentives for qualifying investments\(^3\) associated with initial capital allowances and customs and duties relief.

*The overall METR on capital in the tourism sector is also quite low, at just under 15%. The most important reason for this is the generous 50% investment*

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\(^3\) Minimum investment capital for foreign investors of US$ 300,000 and US$ 100,000 for local investors
allowance. For machinery and equipment the balance is written-off at a relatively higher 37.5% declining balance rate, which is substantially higher than the economic rate of depreciation.

**Recommendations**

- Simplify the VAT system by applying VAT to all tourism and transport services.
- Investigate opportunities to reduce the national VAT rate to the average in the region of around 17% or apply a lower VAT rate to the tourism sector.
- Encourage organized promotional trips by refraining from raising costs as revenue and applying VAT.
- Refrain from applying VAT to gratuities charged and make travel agent commission on air travel exempt from VAT.
- Evenly apply the incentives focused on the imports of tourist vehicles and equipment and machinery across the sector.

**Financial Sector**

The Tanzania financial system is concentrated in commercial banking and very small in relation to the size of the economy. The last two years have witnessed remarkable progress in financial sector development, albeit from a low base. The system is liquid, well-capitalized, profitable, has good asset quality, and resistant to shocks. However, Tanzania’s bank credit to the private sector remains modest, partly because of increased sales of government paper for sterilization purposes.

All financial business activities are VAT exempt. It is common that some, or all, financial services are VAT exempt, largely because it is difficult to determine what the ‘value added’ is of many financial services. Where Tanzania differs from other countries (in the region and internationally) is that financial services firms receive exemption from VAT on capital imports.

*With an overall weighted average METR on capital of just under 29%, the financial sector bears one of the highest marginal tax burdens on capital of the sectors studied.* This is the case for one reason – the VAT. Like many other countries, in Tanzania the activities of banking institutions and other financial services are exempt from VAT. This means that banks do not charge VAT nor are they able to claim input credits for the VAT paid on much of their inputs. Thus, banks can bear a heavy effective sales tax burden on their physical inputs. This is
moderated to some extent by the VAT exemption provided on capital imports at the border. We were not able to obtain information on the share of capital inputs employed by banks that bear VAT. The calculations arbitrarily assume that half of the equipment purchased by financial institutes bears VAT. If, on the other hand, it is presumed that all capital equipment is imported VAT free (none of the equipment purchase by financial institutions bear VAT), then the resulting METR is substantially lower.

**Recommendations**

- Clarify the tax treatment of leasing transactions.
- Require the financial sector to pay VAT on capital imports.
- Equalize the rate of capital gains tax to 10% for residents and non-residents.

**Small Business Sector**

Under the small tax regime, businesses below the turnover threshold of TSH 20 million are required to pay a presumptive tax based on four brackets. The system is flexible and allows small businesses the option to pay a flat payment if no records are kept, or a percentage of turnover plus a smaller flat payment if some records are kept. Small businesses below a TSH 40 million turnover threshold are not required to register for VAT. Voluntary registration is allowed for businesses whose taxable turnover is below the registration threshold but only at the discretion of the Commissioner for VAT.

In Tanzania, small businesses complain about the lack of knowledge regarding tax compliance and recording requirements. Education programs and seminars organized by TRA while welcome have not been effective enough in reaching out to this sector.

METRs for small businesses operating in the manufacturing sector range from 6.7%-15.8% (depending on the income bracket they are in), tourism from 5.1%-12.3% and agriculture from 4%-21.8%. When no VAT is borne by capital inputs the METRs on small businesses are significantly below their large business counterparts. However, as the small businesses move up the tax brackets, their METR approaches, and in some cases exceeds, the METR on large businesses. The reason for this is that turnover taxes are a very blunt tax as they grant no deductions associated with capital expenditures. Non-registration for VAT can have a significant impact on the METRs facing small businesses (as high as
36.7%), as non-registered businesses cannot claim the input tax credit on the VAT levied on their capital purchases.

**Recommendations**

- Simplify presumptive regime.
- Allow easy opt-in for VAT registration.
- Shift to quarterly or bi-annual filing of VAT returns for small taxpayers.
- Increase outreach function under planned Small Business Tax Units to encourage voluntary compliance.

**Zanzibar**

The Government of Zanzibar has autonomy over some, but not all, tax instruments. The Zanzibar Revenue Board (ZRB), which operates on the island in parallel to the TRA, collects VAT, a Hotel Levy, Stamp Duty Levy and Port Services Charges on behalf of the Government of Zanzibar. There is also a restaurant levy, fuel duty and tour operators levy. Customs remain a Union matter, as does income taxation (corporate and personal).

There is anecdotal evidence of misunderstanding between the tourism enterprises and the ZRB and TRA, over what taxes, fees and levies are applicable in what circumstances.

The Government of Zanzibar has instigated Export Processing Zones (The Tanzanian mainland is also considering new Special Economic Zones legislation). There are arguments for and against such vehicles to attract investment depending on what they offer.

**Recommendations**

- Undertake a separate and rigorous assessment of the impact of the dual tax structure on the investment climate in Zanzibar, with a focus on the tourism sector.
- Provide up to date, accurate and accessible information to all business on their tax responsibilities and rights.
Comparison with Neighboring Countries

The METRs in Tanzania are comparable with those in South Africa, Tanzania and Zambia, except for investment in agriculture when the cess tax is included in calculations. METRs on investments in inventories in Tanzania would be reduced dramatically if firms chose the LIFO inventory accounting system. Thus, it seems that tax instruments and rates should not be a significant barrier to investment in Tanzania relative to the tax systems of neighboring countries. However, this analysis does not take into account the administration costs of taxation.

Political Economy of Revenue Collection in Tanzania

The TRA was established in 1995 and became operative in 1996. In contrast to many other revenue authorities in the Region, board and executive management positions in the TRA have been filled with Tanzanians since its establishment.

Annual TRA operations are financed via the general government budget. Since the revenue target constitutes an annually moving target, it does not provide a solid base from which TRA can carry out multi-year planning of its operations. Most of the non-current expenditures are funded by external donors. Since, 1999 donor support has been coordinated by the World Bank, and has included support from several bilateral donors and the UNDP.

The key institutions involved in tax policy formulation are the Policy Analysis Department (PAD) in the Ministry of Finance (preparation of the budget with revenue policy measures), and TRA’s Research, Policy and Planning Department. Some line ministries, including the Ministry of Energy and Minerals, also have a notable influence on tax policy formulation. Moreover, the IMF and the World Bank are involved in policy dialogue, in particular with respect to revenue targets (tax-to-GDP-ratio), policy proposals and technical details.

Consultations between the private sector and government take place in both formal and informal fora, including the Taskforce for Tax Policy Reform; TRA’s Stakeholder Forum; the CEO Roundtable; and the Tanzania National Business Council. In addition, a range of business associations and individual businesses lobby the government on tax issues.

Accountability and political control of the TRA revolves around what authority is delegated to the revenue authority, the depth and detail of monitoring conducted by Parliament and the Ministry of Finance (MoF), and the methods of recourse for those affected by the TRA’s activities, i.e. the taxpayers.
TRA’s current Corporate Plan 2003/04 – 2007/08 includes a set of objectives which address challenges facing the TRA with respect to taxpayers’ compliance, including measures to enhance the administration’s responsiveness, and to address integrity problems and accountability. As such, the TRA has incorporated key elements of modern tax administration, which emphasizes customer friendliness as a major measure to enhance compliance.

TRA has made much progress towards boosting the credibility of the revenue administration. The discontinuation of customs duty exemptions for public sector imports of goods and services in 2002 (down from 18% 1998/99 to 2% in 2005), reflects the government’s commitment to improving compliance. The Government of Tanzania would do well to extend this ‘removal of exemption’ to donors and international agencies.

**Recommendations:**

- Consider installing a system where-by a portion of the TRA’s annual budget is given as an up-front percentage of gross revenue collection.

- Over time, measures are required to secure an unambiguous demarcation of the policy formulating and the policy implementing roles of the MoF and the TRA, respectively.

- Establish a mechanism to ‘filter’ proposals from individual firms, possibly by their member association.

- TRA should consider revising the agenda for the Stakeholder Forum meetings so that they could better accommodate tax policy dialogue in addition to tax information.

- There is an urgent need to build local government capacity in tax design and modern revenue administration.

- The Taxpayer Charter should be developed into a legally binding document.

- Reform VAT and Income Tax Acts so that late payments to and from taxpayers are equivalent at the Bank of Tanzania rate plus five %.

- The Research, Policy and Planning Department of the TRA should conduct a detailed study into the enforcement regime to identify current bottlenecks, and to assess whether these are located within the TRA and/or in the judicial system.
• Further limit tax exemptions, including those granted to aid organizations and their employees.
1. INTRODUCTION

Background

This FIAS/DFID report forms part of a series of studies designed to improve understanding of the impact of tax policy, and in particular its administration, on the business climate in southern Africa.

The establishment of semi-autonomous revenue authorities (RAs) in various countries in the region has contributed to increased tax collection. However, an unforeseen consequence of creating RAs may have been to strengthen RA incentives to maximize revenue generation while weakening the authority of ministries of finance to formulate tax policy for broader national needs - especially business development, investment and growth for sustainable poverty reduction. There has been little focus on the possible business and growth impacts of revenue targets and internal performance incentives.

This project therefore aims explicitly to develop understanding on business impacts of African RAs’. ‘Doing Business 2006’\(^4\) showed that countries which tax highly and have complex regulations (and hence provide strong incentives to evade), generally receive lower tax revenues than countries with low rates and broader tax bases. Reflecting on examples of successful policy reform, this series of studies will suggest reforms in both tax policy and administration that may stimulate savings, investment and growth – such as through selectivity/disciplining of rents/security of rents, and tax exemptions.

The study uses both quantitative and qualitative techniques to address these concerns. The quantitative component uses Marginal Effective Tax Rate (METR) techniques to investigate how the tax code, as defined in legislation, benefits certain sectors over others. The qualitative component addresses in more detail how tax administration works in practice, including a political economy analysis of the TRA and Ministry of Finance as institutions.

Tax impact on business in wider context

This study recognizes that maintaining revenue for necessary government expenditures is critical, and that any tax policy or administration reforms (including those in this report) need to take into account the revenue implications. However, ‘investment friendly’ tax reforms need not threaten the fiscal base and may indeed enhance it. Simpler tax systems encourage compliance and

\(^4\) See footnote 2.
discourage evasion and avoidance; lower tax rates can spur growth leading to increased revenue collection in the medium to long term; and the elimination of expensive incentives can boost revenue with immediate effect.

In many cases sub-national taxation or customs may have a larger impact on businesses than national taxes. Surprisingly little information is available on what percentage and kind of taxes are being paid by what type or size of business in sub-Saharan Africa – not only at the national level (the primary focus of this project), but also at sub-national level and on international trade. This data is necessary for a complete picture of where the burden of taxes and compliance costs falls most heavily and what distortions to growth patterns may result. These broader issues are beyond the scope of this project, but it is hoped that they will be explored in due course, perhaps through the Investment Climate Facility for Africa currently being established.

This project appreciates that tax may be only a small part of the wider picture of what affects the incentives to invest. Other factors may include economic governance, infrastructure, security etc.

**Context of the Study in Tanzania**

The Government is focused on tackling the structural problems of poverty reduction and is fully aware that strong growth, led by private sector investment, is a key to helping the Tanzanians improve their living conditions and make solid progress toward achieving the Millennium Development Goals. To that end, the Government is committed to pursuing the reform agenda and removing barriers to entry or growth of private businesses, to overcome a perception of Tanzania as a high-risk market, unattractive to existing and potential investors, both foreign and domestic. The Government of Tanzania is addressing these issues through streamlining the business environment, lowering the cost of doing business and facilitating the emergence of a strong local business community by providing financial and non-financial services.

The recently published Poverty Reduction Strategy Paper (‘MKUKUTA’ in Kiswahili) acknowledges that enhanced efforts are needed to stimulate private-sector led growth, particularly in such areas as infrastructure, access to the financial sector, improving the business environment and governance.
Since 1993, the Government of Tanzania has made headway in its transition to a more market based economy. It passed the Tanzania Investment Act in 1997 and set up the Tanzania Investment Centre (TIC). An important milestone in this process was the 1996 ‘Tanzania Investor Roadmap’, which had a big impact, demonstrating that the regulatory and tax environment in Tanzania was among the most discouraging in the sub-region.5

The Roadmap stated “While the current regulatory environment is difficult for medium and large scale formal sector firms, it is largely inappropriate and irrelevant to micro and small scale informal businesses.”

**Tanzania: Economic Background**

**Growth and performance in the past**

Table 1 shows that Tanzania has achieved robust growth over the last five years. Although growth has slowed more recently, it remains well above the average for sub-Saharan Africa.

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5 UNDP (2002).
Table 1: Tanzania: Economic Data 2001 - 2005

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<td>GDP at market prices (TSh bn)</td>
<td>8,274.1</td>
<td>9,445.9</td>
<td>10,692.4</td>
<td>10,090.3</td>
<td>11,264.0</td>
</tr>
<tr>
<td>GDP (US$ bn)</td>
<td>9.4</td>
<td>9.8</td>
<td>10.3</td>
<td>9.3</td>
<td>10.0</td>
</tr>
<tr>
<td>Real GDP growth (%)</td>
<td>6.2</td>
<td>7.2</td>
<td>7.1</td>
<td>6.7c</td>
<td>6.8</td>
</tr>
<tr>
<td>Consumer price inflation (av; %)</td>
<td>5.1</td>
<td>1.0</td>
<td>3.5</td>
<td>4.1a</td>
<td>4.2</td>
</tr>
<tr>
<td>Population (m)</td>
<td>34.4</td>
<td>35.2</td>
<td>35.9</td>
<td>36.7</td>
<td>37.4</td>
</tr>
<tr>
<td>Exports of goods fob (US$ m)</td>
<td>811.7</td>
<td>911.6</td>
<td>1,156.6</td>
<td>1,278.1a</td>
<td>1,595.7</td>
</tr>
<tr>
<td>Imports of goods fob (US$ m)</td>
<td>1,631.4</td>
<td>1,526.5</td>
<td>1,980.4</td>
<td>2,184.1a</td>
<td>2,378.7</td>
</tr>
<tr>
<td>Current-account balance (US$ m)</td>
<td>-456.6</td>
<td>-216.9</td>
<td>-393.4</td>
<td>-437.1a</td>
<td>-479.5</td>
</tr>
<tr>
<td>Foreign-exchange reserves excl gold (US$ m)</td>
<td>1,156.6</td>
<td>1,528.8</td>
<td>2,038.4</td>
<td>2,295.7a</td>
<td>2,048.8</td>
</tr>
<tr>
<td>Total external debt (US$ bn)</td>
<td>6.8</td>
<td>7.3</td>
<td>7.5</td>
<td>7.9</td>
<td>7.7</td>
</tr>
<tr>
<td>Debt-service ratio, paid (%)</td>
<td>9.7</td>
<td>6.6</td>
<td>4.7</td>
<td>6.6</td>
<td>6.6</td>
</tr>
<tr>
<td>Exchange rate (av) TSh:US$</td>
<td>876.4</td>
<td>966.6</td>
<td>1,038.4</td>
<td>1,089.3a</td>
<td>1,128.9a</td>
</tr>
</tbody>
</table>

a Actual. b Economist Intelligence Unit estimates. c Official estimate
Source: Economist Intelligence Unit 2005

Sector contributions to growth

This study gives priority to five sectors, chosen because of their important contribution to current output and production and for their potential for growth and new investment. These are: agriculture, mining, manufacturing, tourism and financial services. Together these five sectors represent around 63% of total GDP.

Table 2: Tanzania: Sector contribution to total GDP, 1999-2005 (% GDP)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, Forestry, Fisheries and Hunting</td>
<td>45.0</td>
<td>44.7</td>
<td>44.7</td>
<td>45</td>
<td>46.2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>7.50</td>
<td>7.40</td>
<td>7.30</td>
<td>7.20</td>
<td>7.00</td>
</tr>
<tr>
<td>Mining</td>
<td>1.50</td>
<td>1.60</td>
<td>1.80</td>
<td>1.90</td>
<td>2.50</td>
</tr>
<tr>
<td>Tourism ('Trade, hotels and restaurants')</td>
<td>12.30</td>
<td>12.20</td>
<td>11.90</td>
<td>11.80</td>
<td>11.70</td>
</tr>
<tr>
<td>Financial and business services</td>
<td>13.70</td>
<td>14.10</td>
<td>14.30</td>
<td>14.30</td>
<td>13.70</td>
</tr>
<tr>
<td>Other (inc. construction, transport, public sector, electric &amp; water)</td>
<td>20.20</td>
<td>19.70</td>
<td>19.00</td>
<td>18.60</td>
<td>19.70</td>
</tr>
<tr>
<td>Total Monetary GDP</td>
<td>71.20</td>
<td>71.00</td>
<td>71.20</td>
<td>71.00</td>
<td>71.00</td>
</tr>
<tr>
<td>Total Non-Monetary GDP</td>
<td>28.80</td>
<td>29.00</td>
<td>28.80</td>
<td>29.00</td>
<td>29.00</td>
</tr>
<tr>
<td>Total GDP at factor cost</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source: IMF, Tanzania: Selected Issues and Statistical Annex, 2004; Economist Intelligence Unit, Tanzania Country Profile 2005
Tanzania is predominantly an agriculturally based economy and the majority of agricultural production is subsistence. Notable from Table 2 is the stagnation in the share of different sectors. There has been no significant shift in the economic contribution of the various sectors. While mining has grown considerably, and is a major export earner, it remains a small component of GDP.

Table 3: Tanzania: Sector Growth, 2000-2005

<table>
<thead>
<tr>
<th>Sector</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, Forestry, Fisheries and Hunting</td>
<td>3.4</td>
<td>5.5</td>
<td>5.0</td>
<td>4.0</td>
<td>6.0</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>4.8</td>
<td>5.0</td>
<td>8.0</td>
<td>8.6</td>
<td>8.6</td>
</tr>
<tr>
<td>Mining</td>
<td>13.9</td>
<td>13.5</td>
<td>15.0</td>
<td>18.0</td>
<td>15.6</td>
</tr>
<tr>
<td>Financial and business services</td>
<td>4.7</td>
<td>3.3</td>
<td>4.8</td>
<td>4.4</td>
<td>4.5</td>
</tr>
<tr>
<td>Construction</td>
<td>8.4</td>
<td>8.7</td>
<td>11.0</td>
<td>11.0</td>
<td>11.0</td>
</tr>
<tr>
<td>Transport, Storage &amp; Communications</td>
<td>6.1</td>
<td>6.3</td>
<td>6.4</td>
<td>5.0</td>
<td>6.2</td>
</tr>
<tr>
<td>Electric &amp; Water</td>
<td>5.9</td>
<td>3.0</td>
<td>3.1</td>
<td>4.9</td>
<td>4.7</td>
</tr>
<tr>
<td>Total GDP at factor cost</td>
<td>4.9</td>
<td>5.7</td>
<td>6.2</td>
<td>5.7</td>
<td>6.7</td>
</tr>
</tbody>
</table>

Source: EIU, *Tanzania Country Profile 2005*

Table 3 shows the highest growth has been in the mining sector (partly as the base was almost zero). But all sectors have shown positive growth in nominal terms.

**Foreign direct investment in Tanzania**

FDI has risen in recent years to an average of $380 million per annum since 1997, which equates to 4.1% of GDP. The average for sub-Saharan Africa is 2.6% of GDP. Much of this can be attributed to the growth in mining investment and the government’s privatization program (begun in 1986).
The business climate in Tanzania

The World Bank’s ‘Doing Business’ project provides a good starting point for assessing Tanzania’s investment climate. In nearly every category of the survey, Tanzania’s Doing Business indicators performance are in line with or better than the African regional average. Even so, Tanzania’s overall place was only 140th out of 155.

Tanzania fared less well on dealing with licenses, where it was ranked 150th, since compliance with licensing and permit requirements for ongoing operations take an average of 26 procedures over the course of 313 days, and cost 4,110.2% of income per capita (nearly three times regional average, and more than fifty times OECD average). Tanzania was also marked a poor 125th for getting credit, and 144th for protecting investors.

On taxes, while Tanzania has a comparable number of taxes to the region (48 vs. 41), this is nearly three times the number of taxes paid in OECD countries. Tanzania performs better in terms of the time taken to complete tax forms with 248 hours, which is well below the regional average of 394 and not far above the OECD average of 197.
Table 4: Doing Business in Tanzania

<table>
<thead>
<tr>
<th></th>
<th>Tanzania</th>
<th>Region</th>
<th>OECD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Starting a business Procedures</td>
<td>13</td>
<td>11</td>
<td>6.5</td>
</tr>
<tr>
<td>Time (days)</td>
<td>35</td>
<td>63.8</td>
<td>19.5</td>
</tr>
<tr>
<td>Cost (% of income per cap)</td>
<td>161.3</td>
<td>215</td>
<td>6.8</td>
</tr>
<tr>
<td>Minimum capital (% income per cap)</td>
<td>6.0</td>
<td>297</td>
<td>41</td>
</tr>
<tr>
<td>Dealing with licenses Procedures (days)</td>
<td>26</td>
<td>20.1</td>
<td>14.1</td>
</tr>
<tr>
<td>Time (days)</td>
<td>313</td>
<td>251.5</td>
<td>14.1</td>
</tr>
<tr>
<td>Cost (% of income per cap)</td>
<td>4,110.2</td>
<td>1597.3</td>
<td>75.1</td>
</tr>
<tr>
<td>Paying taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payment Number</td>
<td>48</td>
<td>41</td>
<td>16.9</td>
</tr>
<tr>
<td>Time (hours)</td>
<td>248</td>
<td>394</td>
<td>197</td>
</tr>
<tr>
<td>Total tax payable (% gross profit)</td>
<td>51.3</td>
<td>58</td>
<td>45</td>
</tr>
</tbody>
</table>


There have been a number of investment climate assessments in Tanzania in recent years, including by UNCTAD (2002), the CUTS Centre for Competition, Investment and Economic Regulation (2003) and the World Bank (2004). All these studies identify tax policy and administration as an inhibitor to investment. The World Bank notes “Tax rates were more likely to be considered a serious problem than any other constraint, with 73% of enterprises rating them as a major or very severe obstacle. In fact, more enterprises rated tax rates as a serious problem in Tanzania than in any of the other countries where Investment Climate Assessments had been completed by the end of 2003 (except Ethiopia and Brazil).”

On tax, the World Bank concludes, “Anecdotal evidence suggests that complaints about tax rates largely reflect concerns about the multiplicity of national and local taxes and fees. A follow-up study on the marginal effective tax rates facing firms of different types (e.g., along the lines of a FIAS incentives review) could help provide specific recommendations on streamlining the tax system.” This report responds specifically to that recommendation.

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Note: Many of the issues raised by the World Bank ICA are focused on sub-national taxes and levies, a problem which has been partially solved by reforms in 2004 (see ‘Institutional and Organizational Issues’).
Tax Policy in Tanzania

Tax and incentive policies are key parameters in defining a business climate. Taxes are essential for the financing of government activities, but at the same time, they should be set and administered to be as growth enabling as possible. Revenue raising authorities therefore, (in the Tanzania case it is the Ministry of Finance that sets tax policy and the Tanzania Revenue Authority [TRA] that administers it) must strive to set a tax policy that meets both needs.

Foundations and Background

Existing legislation

- Constitution of the United Republic of Tanzania, 1977
- Income Tax Act 2004
- The East African Community Customs Management Act, 2004
- The East African Community Customs Tariff Act, 2004
- The Excise Tariff Ordinance (Cap.332)
- The Stamp Duty Act, 1972
- The Road and Fuel Toll Act, 1985
- The Airport Service Charges Act, 1992
- The Vocational Education and Training Act, 1994
- Various local taxes and charges (see Box 21).
- The Local Government Finances Act, 1982

Tanzania has also concluded Double Taxation Treaties with Denmark, Italy, Norway, Sweden, Canada, Finland, India, Zambia, Uganda and Kenya.

Description of tax instruments described in this study

This study will concentrate on taxation whose burden falls on the corporate sector. The primary taxes are:
- Corporate income tax
- Value Added Tax (VAT)

In addition, companies may have to pay the following contributions during their operations, depending on the type of business:
- Customs duty
- Excise tax
- Witholding tax
- Capital gains tax
- Skills development levy
The general corporate tax rate is 30% of profits in line with the countries in the East African Community (EAC) and wider region. All operational expenses (rent, advertisements, packaging, repairs etc.) related to the business can be deducted from revenue to form the taxable income base. Losses may be indefinitely carried forward.

Businesses with an annual turnover of less than TSH 20 million automatically pay a presumptive tax according to (a) their turnover, and (b) whether the business keep their own record of turnover.

VAT of 20% is charged on both local and imported goods and services. Businesses must keep invoices for five years. Taxable value is the selling price plus excise taxes, if applicable. Certain items are either zero-rated (subject to the VAT at the zero rate with refunds previously paid) or exempt from VAT (not subject to the VAT Act’s provisions). Although there are no clear published criteria for the decision whether to assign an item to zero-rating or exemption, in keeping with most VAT regimes, zero-rating and exemption is focused on protecting low income consumers. The differentiation allows businesses to obtain refunds of VAT already paid on inputs used to produce zero-rated items, while the VAT collected on inputs used to produce goods exempt from the VAT cannot be refunded. Major zero-rated items are necessities, exports and diplomatic imports.

Tables 5 and 6 provide data on Tanzania’s customs duties and VAT rates – with a comparison to other countries in the region.

**Table 5: Regional VAT Rates**

<table>
<thead>
<tr>
<th>Country</th>
<th>VAT Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kenya*</td>
<td>16%</td>
</tr>
<tr>
<td>Lesotho</td>
<td>14%</td>
</tr>
<tr>
<td>Malawi</td>
<td>17.5%</td>
</tr>
<tr>
<td>Mozambique</td>
<td>17%</td>
</tr>
<tr>
<td>Namibia</td>
<td>15%</td>
</tr>
<tr>
<td>Rwanda</td>
<td>18%</td>
</tr>
<tr>
<td>South Africa</td>
<td>14%</td>
</tr>
<tr>
<td>Swaziland</td>
<td>14%</td>
</tr>
<tr>
<td>Tanzania</td>
<td>20%</td>
</tr>
<tr>
<td>Uganda</td>
<td>18%</td>
</tr>
<tr>
<td>Zambia</td>
<td>17.5%</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>17.5%</td>
</tr>
</tbody>
</table>

*A reduced rate of 14% is applied to the restaurant and accommodation industries.

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8 Designated in the Second Schedule of the VAT Act.
Table 6: Regional (Nominal) Tariff Rates

<table>
<thead>
<tr>
<th></th>
<th>Capital goods</th>
<th>Raw materials</th>
<th>Semi-finished goods</th>
<th>Finished goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rwanda</td>
<td>0%</td>
<td>5%</td>
<td>15%</td>
<td>30%</td>
</tr>
<tr>
<td>Uganda</td>
<td>0%</td>
<td>0%-7%</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>Kenya</td>
<td>0%</td>
<td>0%-3%</td>
<td>5%-15%</td>
<td>20%-35%</td>
</tr>
<tr>
<td>Tanzania</td>
<td>0%</td>
<td>0%</td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td>Zambia</td>
<td>0%</td>
<td>0%-5%</td>
<td>15%</td>
<td>25%</td>
</tr>
</tbody>
</table>


Tax Revenue Performance

From a macroeconomic perspective, tax policy in Tanzania has been increasingly effective at raising revenues, as measured by tax/GDP ratios. The current tax/GDP is 14.0% of GDP, up from 12.9% in 1996. However, this is still less than Kenya (22.7%) or Malawi (17.5%).

Total central government revenues in 2004 amounted to 1,459 billion TSH (approximately US$1.204 billion). External donor financing plays a significant role in Tanzania’s budget. In 2004 donor contributions (including assistance under the Heavily Indebted Poor Country Initiative) amounted to 41% of expenditure.

Tanzania’s reliance on import taxes has steadily fallen, and now VAT contributes the largest share of total revenue (39%). Corporate and personal income taxes contribute 7.9% and 15.9% respectively. Figure 2 illustrates the contributions. That VAT contributes such a large contribution (compared to both other tax instruments and other regional countries with VAT) is unsurprising given that Tanzania’s VAT is the highest in the region at 20%.
Tanzania’s Poverty Reduction and Growth Facility with the IMF contains several measures designed to improve revenue performance, these are:

- Expanding the coverage of the Large Taxpayer Department to 250 Taxpayers (observed);
- Completing the quality assurance review of the Customs and Excise Department reforms under the TRA's second corporate plan (observed);
- Submitting to parliament an amendment of the Tanzania Investment Act, to limit the applicability of fiscal stability clauses to at most 5 years (observed).
2. ANALYSIS OF THE EFFECTIVE TAX BURDEN IN TANZANIA

Assessing the effective tax burden - an introduction

A quantitative assessment of the effective tax burden in Tanzania requires a standardized metric, which takes all provisions of the tax code and incentives scheme in place to look at what a hypothetical new entrepreneur would face if he or she were to invest today in that sector. At the same time, qualitative analysis is also needed to determine how the tax/incentives scheme is applied in practice. This section presents both the qualitative and quantitative analyses of five key sectors in the economy—agriculture, manufacturing, tourism, mining, and finance—to present a comprehensive picture the absolute and relative tax burden.

Quantitative analysis of the effective tax burden – Marginal Effective Tax Rate Analysis (METR)

The concept of a marginal effective tax rate (METR) was created to analyze in a single measure how investment decisions are affected by the large number of provisions of the business and individual income tax systems, as well as by features of any property and wealth taxes, sales taxes including VAT, customs duties, and special incentive regimes such as tax holidays, that affect the incentives to invest. METR analysis is based on the standard neoclassical model of investment in which the level of investment is a function of the “cost of capital” faced by a firm – the minimum or “hurdle” rate of return that an investment must earn to be profitable. Although earlier research was mixed on the issue, the most recent empirical evidence confirms the basic assumption of this model – which investment does in fact react inversely to changes in the cost of capital (Gordon and Hines, 2002). METR analysts, such as King and Fullerton (1984), Broadway, Bruce and Mintz (1984) and many others, have taken the basic neoclassical model and modified it to take into account the net effect of all the provisions of a tax system on the cost of capital to the firm. The primary goal of an METR analysis is thus to describe this net effect of a tax system on investment incentives in a straightforward and intuitively appealing form.

---

The METR terminology naturally provides some insight into the nature of this tool. A METR is marginal because it is based on analysis of a prospective incremental investment – one that just breaks even, with its after-tax cost equal to its after-tax returns. It calculates the effective tax burden in that it captures the net effects of all the provisions of the tax system, rather than focusing on a single characteristic such as the maximum statutory corporate tax rate. And it is a tax rate in that it is defined as the difference between the gross of tax and net of tax returns to an investment – the “tax wedge” between gross and net returns created by the tax system – expressed as a percentage of the gross return.

The calculation of a METR requires careful specification of the characteristics of an investment in a specific asset in a specific sector. This includes the time path of its returns, the rate of economic depreciation of the asset, how the asset is financed, the economic environment in which it occurs, including the inflation rate, interest rates, and returns to equity, and all of the features of the current or proposed tax system that affect both the after-tax returns and the after-tax costs attributable to the investment, including all tax depreciation allowances, investment credits, interest deductions, special exemptions, etc., allowed under the income tax as well as any other taxes that impinge on investment decisions. (See Box 2 for an explanation). Given this information, the analysis calculates the effective tax rate on a marginal or breakeven investment under the assumptions of profit maximization by the firm, competitive markets, and perfect certainty (e.g. with respect to future returns and inflation rates).

A few technical assumptions for the METR calculations used in this paper are also worth noting. First, the METR should not be confused with the average effective tax rate (AETR). The AETR measures total taxes as a share of total income while the METR measures taxes paid by a marginal investment as a share of the required before-tax rate of return on that investment. The METR is thus a forward looking measure which measures the impact of taxes on the incentive to invest at the margin. The AETR is a backward looking measure which reflects previous investment decisions and taxes levied on the income generated by those past investments. METRs and AETRs can differ significantly. In particular, it is quite possible for the AETR to be quite high and the METR quite low, or vice-versa. Both measures are useful for tax policy analysis, but serve quite different purposes. The METR provides a measure of the incentive effects of the tax system on investment. The AETR provides a measure of the burden of the business tax system and is a useful indicator of the distribution of the business tax burden across companies or sectors.

---

10 METR analysis is thus not well suited to analyzing tax effects on investments that generate above-normal returns.

11 To make matters even more confusing, average effective tax rates are often referred to as implicit tax rates.
Second, it is important to understand that the METR measures the impact of taxation on the incentive to invest in capital inputs. Taxes that corporations pay on other inputs that do not impinge on the rate of return to capital, in particular various taxes imposed on labor, such payroll taxes, are not reflected in the METR on capital.

Third, it is important to emphasize that METR analysis is only one of several tools that should be employed in the analysis of the tax system. The calculations are based upon a hypothetical marginal capital investment subject to a rough caricature of the tax system. While several important aspects of the tax system can be incorporated into the calculations – such as the corporate income tax rate, tax depreciation allowances, investment allowances, tax credits, property and capital taxes, tax holidays, implicit sales taxes on inputs, the treatment of inventories, etc. – several simplifying assumptions must be made, and important nuances of the tax code cannot be captured in METR calculations. The methodology thus captures only the “big picture” aspects of the tax code and should be interpreted in this light.

Finally, it is important to note that the METR calculations reflect the statutory provisions of the tax system. As a rule, METR calculations do not reflect various administrative and compliance issues that are extremely important in determining how a tax system works “on the ground.”

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12 An example is loss carry-forward provisions. While it is possible to incorporate loss carry-forwards, this requires detailed information on the anticipated future profile of income and taxes, which is typically not available in reliable form.

13 An attempt to illustrate the importance of these issues in the METR framework is undertaken below.
Box 2: The Marginal Effective Tax Rate (METR)

The METR measures the extent to which the tax system reduces the real rate of return on investment, at the margin. More formally, the METR is defined as:

\[
\text{METR} = \frac{\text{ROR}_b - \text{ROR}_a}{\text{ROR}_b}
\]

where \(\text{ROR}_b\) and \(\text{ROR}_a\) are the real rates of return before and after tax. The ROR can be found either using an economic approach (e.g. Boadway, Bruce and Mintz 1984) or an accounting approach (Dunn and Pellechio 1990). The analysis in this paper most closely follows the economic approach.

For example, let us assume that the rate of return on an incremental capital project is 20% before tax and 10% after tax, from the equation: \(\text{METR} = \frac{20-10}{20} = 0.5\) or 50%. The METR of 50% indicates that the tax system diminishes the real rate of return by 50%. Alternatively, it indicates that 50% of the before-tax rate of return is required to pay the taxes arising from a marginal investment. The METR shows how much the tax system distorts investment incentives by driving a 'wedge' between the underlying profitability of a project and the after-tax return to the investor. The METR can be compared across projects, sectors, and countries. The larger the METR, the bigger the tax wedge. Differences in the METR reveal tax-induced biases in the incentives that drive the allocation of productive resources. In some cases, the biases are deliberate aims of policy, such as preferences for exporters or for manufacturers in certain locations. In many cases, however, the biases are unintended consequences of the tax system.

It is possible to have a METR which is zero and yet also revenue-positive, as long as the rates of return before and after tax are the same. This can be the case with, for example, 100% deductibility of investment in the first year (under no debt financing).

The tax wedge appears at two levels—one arising from taxes on the company, and the second stemming from taxes on the remittance of earnings or capital gains to the owners. There are thus two METRS. The first is in terms of the returns seen by the company undertaking the investment. The second analyses the rate of return to the equity holders themselves rather than the company. The present paper uses the second approach.

Taxes on capital can lead to several types of distortions in an economy. First, a high overall METR on capital is indicative of a tax system that discourages investment, generating what might be called an inter-temporal distortion. Second, differences in METRs across assets suggest a tax system that distorts the allocation of investment across different types of capital – inter-asset distortions. Third, differences in METRs across sectors are indicative of a tax system that introduces distortions in the allocation of investment across industries, leading to inter-sectoral distortions.

All of these types of distortions – inter-temporal, inter-asset and inter-sectoral – can lead to an inefficient allocation of resources in the economy, and therefore to an economy that does not produce to its capacity, does not generate jobs to its capacity, and therefore does not grow to its capacity.
Illustrative METR calculations for Tanzania are summarized in Table 7 for different sectors and assets and under varying assumptions regarding the openness of capital markets, VAT registration, etc. Several different types of taxes are modeled in the calculations, including: the corporate income tax, stamp duties, the presumptive regime for small businesses, the city levy, the cess in the agricultural sector, and royalties in the mining sector. Where applicable VAT implicitly imposed on capital inputs is included (due, for example, to non-registration in the small business sector). Not included in the analysis are fixed license fees and levies, and local property taxes.

The calculations in Table 7 are for all non-small corporations (i.e. those that are above the threshold for the turnover presumptive tax and are registered for VAT), and therefore assume that the capital market in Tanzania is small and open to internationally mobile capital. For these firms personal income taxes on the return to savings (interest, dividends, capital gains) paid by domestic (Tanzanian) investors do not affect the METR on capital, and therefore have no impact on the incentive to undertake investment. This follows from the fact that the required after-corporate-tax rate of return on investments in a small open economy is fixed by international financial markets, which results in a disconnect between domestic savings and domestic investment, with shortfalls of domestic saving made up by international capital flows. This is a reasonable assumption for larger firms, and is commonly made in METR studies.

For micro and small scale enterprises (MSSEs), on the other hand, the assumption of internationally mobile capital in an open economy is less appropriate, as these businesses do not have access to international financial markets but must rely on local investors for funds. For these MSSEs, which may be thought of as “entrepreneurial firms”, the local capital market can be viewed as closed, and domestic personal taxes levied on the return to savings can distort investment decisions in these types of firms. For comparison purposes, the Small Businesses section below present a set of calculations for small businesses under the small open capital market assumption (Table 21), but we also present a set of calculations under the closed local capital market assumption (Table 22). The Small Business Section provides more details.

We elaborate on the formulas underlying the calculation of METRs, and in particular on the distinction between the closed and open economy calculations, in Annex A.

Before considering the detailed calculations, and by way of summary, in our assessment the statutory structure of the corporate income tax system in

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14 An Annex is provided which discusses the concept of the METR and the distinction between the open and closed economy cases in more detail.
Tanzania is fundamentally sound. At 30% the CIT rate is in line with other regions, though there may be some scope for a reduction. With some exceptions, tax holidays have been eliminated. Tax holidays are an extremely inefficient and costly way of offering tax incentives. Instead, incentives are offered by way of a broadly based (although perhaps overly generous) investment allowance and fast-write-offs in specific sectors. The use of declining balance depreciation in the context of relatively few capital classes is also in accordance with best practices for countries at Tanzania’s level of development. Finally, the option to use LIFO for tax accounting purposes helps reduce the inflation tax on inventories, and is also in accordance with best practices.

Table 7, large corporations, shows that there is quite a bit of variation in METRs across assets for any particular sector. These primarily reflect discrepancies between the rate at which firms are able to write-off capital expenditures for tax purposes (tax depreciation), and the rate of decline in the market value of the capital due to obsolescence, wear and tear, etc. (called economic depreciation). Both tax and economic depreciation rates vary across assets and sectors. In particular, with the exception of the Finance sector (though see the discussion below), investments in equipment and land tend to face very low METRs relative to buildings and inventories.

There is also variation across sectors due to differences in the tax treatment of different types of capital across sectors, but also to differences in economic depreciation rates and to different capital weights used to aggregate the METRs on individual assets into an aggregate METR. For example, equipment accounts for over 50% of capital investment in the broad manufacturing sector, but only for around 20% in Tourism and Agriculture. Similarly, the economic depreciation rate on buildings in the Agricultural sector is about half that in the Manufacturing sector. This means that if buildings are written-off for tax purposes at the same rate in the two sectors, the treatment is more generous for Agriculture than it is for Manufacturing.

Overall, our calculations for large firms suggest that the METRs on capital in Tanzania are relatively low. Particularly important in this regard is the very generous investment allowance (50%) available in the first year, coupled with relatively high write-off rates thereafter. Also important is the fact that Tanzanian companies have the option of choosing LIFO inventory accounting for tax purposes which eliminates the inflation tax imposed on inventories and lowers the METR on inventories substantially.15

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15 Despite this, international experience suggests that when given the choice some firms opt for FIFO accounting nonetheless as LIFO can understate profits for financial statement purposes. We have accounted for this in the calculations.
Amongst larger corporations, Manufacturing, Tourism and Mining (ignoring the royalty) face the lowest aggregate METR on capital, in the 13% to 15% range. The overall METR in Agriculture is slightly higher at 23%, with the Finance sector facing a slightly higher METR of 29%. The METRs on capital in the small business sector vary substantially depending upon the circumstances of the business, in particular with respect to VAT registration, but also depending upon the tax bracket. The ensuing discussion will highlight the reasons for these differences.

A comparison of the METRs in Tanzania relative to other regional countries is contained in Tables 25-27. For the most part Tanzania is competitive in terms of the METRs, though there are some exceptions. An exception to the lower METRs in Tanzania is the Agriculture sector where the higher METR rates reflect the imposition of the cess on turnover.

Investments in manufacturing and tourism in Tanzania face particularly low METRs. This is due largely to the generous 50% investment allowance and relatively high subsequent write-off rates. Inventories also face relatively low METRs in Tanzania relative to some of its neighbors. This is the case because of the option to use LIFO for inventory accounting purposes and the relatively low inflation rates in Tanzania.

Table 7: Marginal Effective Tax Rates on Capital: Tanzania, Large Corporations, Open Economy

<table>
<thead>
<tr>
<th></th>
<th>Manufacturing</th>
<th>Agriculture</th>
<th>Mining</th>
<th>Finance</th>
<th>Tourism</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No cess</td>
<td>cess</td>
<td>No Royalty</td>
<td>Royalty</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>3.8%</td>
<td>-35.1%</td>
<td>-36.7%</td>
<td>13.4%</td>
<td>42.5%</td>
</tr>
<tr>
<td>Buildings</td>
<td>27.7%</td>
<td>3.6%</td>
<td>16.3%</td>
<td>25.3%</td>
<td>36.4%</td>
</tr>
<tr>
<td>Land</td>
<td>1.6%</td>
<td>1.6%</td>
<td>8.7%</td>
<td>1.6%</td>
<td>7.3%</td>
</tr>
<tr>
<td>Inventories</td>
<td>21.9%</td>
<td>21.9%</td>
<td>27.5%</td>
<td>21.9%</td>
<td>26.4%</td>
</tr>
<tr>
<td>Weighed average</td>
<td>15.3%</td>
<td>6.2%</td>
<td>23.1%</td>
<td>-3.0%</td>
<td>22.5%</td>
</tr>
</tbody>
</table>

16 The negative METRs in Zimbabwe, except for inventories, reflects the extremely high inflation rates in Zimbabwe (in excess of 50%). Inflation of this magnitude interacts with the tax system in a perverse way.

17 ‘Large’ in the context of this analysis is defined as any firm over the VAT threshold, keep accounts, paying the standard corporate income tax regime and making use of incentives where available.
Sector Analysis

Agriculture

Agriculture is the largest sector of the economy and accounts for 26% of formal GDP and an estimated 90% of the informal economic activity (EIU 2005). Coffee, tea, sisal and cashews are some of the main export crops.

The majority of farms are informal and predominantly subsistence. The vast majority of farms operate outside of the tax net, either because produce is not sold commercially or because the size of the business is so small. The exceptions to this are the farmers growing cash crops sold to traders or central buyers. In these situations, ‘cess’ taxes are collected by traders on behalf of local authorities. Some farmers also pay national taxation, if the system exists to assess this and recoup it (for example of a farmer sells to a central processing facility, as in the case of sugar cane).

Summary of the tax/incentive system

The agricultural sector, as is common, receives favorable tax treatment.

Corporate Income Tax

Those farmers that do keep accounts may immediately expense all research and development expenditure and capital expenditure. These benefits, combined with unlimited loss carry-forward, results in a significantly reduced tax burden for farmers that fall under the corporate income tax regime.

Most farmers in Tanzania, if they were to pay tax, would fall under the presumptive regime for direct taxation (see Small Business discussion) – as they would have a turnover of less than TSH20 million.

Value Added Tax

All farming outputs and inputs (including equipment) are VAT exempt. The same is not true however, for value added processing of agricultural products or for input services, which some farmers may purchase (contacted in tilling, harvesting, transport etc). Farm enterprises benefit from all of the following being zero rated for import duty as well as being VAT exempt: all capital goods, agricultural machinery, fertilizer and pesticides, farm implements (imported or made locally) and one-non utility administration vehicle.
Other taxes / relief

The agricultural sector is exempt from withholding taxes on foreign sourced loans, exempt from the 6% Skills Development Levy and face a reduced withholding tax on dividends of 10%.

Farm enterprises are however, not exempt from fuel excise duty and VAT on fuel, in contrast to the mining sector. Fuel, (for mechanized farming or transportation of inputs and outputs) make up a significant proportion of farmers costs.

Tanzania imposes an export tax of 15 % on raw hides and skins to assist the domestic tanning and leather industry. There are also smaller levies on exports of other products, including fish, cashews and cotton.

The Tax and Incentive Regime in Practice

Tax is not a major issue constraining investment in this sector. Other factors are more important in driving growth and investment in this sector, issues such as land tenure reform, lack of skills, access to credit and poor rural infrastructure.

Corporate Income Tax

In practice, very few farmers pay corporate income tax. This is either due to official incentives (outlined above) or lack of compliance. Non-compliance is due to a combination of a lack of understanding of tax obligations and geographical remoteness. Such a situation is common in countries with a large number of smallholder farmers.

It is only larger (incorporated) farmers who are likely to benefit from the relief provided on capital (duty, VAT, 100% deduction) and exemption from the Skills Development Levy.

VAT

As both agricultural inputs and outputs are VAT exempt, the result is that VAT does not apply in the sector. The only exception to this is when farmers purchase services inputs, in which case VAT applies.
### Box 3. How to tax Agriculture?

It is a common feature of tax regimes that agriculture is taxed relatively lightly. The sector receives ‘special’ treatment because:

- In many developing countries agriculture is small scale, subsistence and outside the formal sector
- Farmers are remotely located making education and compliance difficult
- Agriculture has seasonal revenues
- Farmers often operate on very low incomes and make a disproportionate percentage of the poor.

Many of these features are not unique to agriculture and there is no *a priori* evidence that agriculture deserves special treatment. The reality however, is that special provisions are usually provided. Regimes include:

**Direct Taxes:**

1. **Income tax**
   - on actual income (scheduler)
   - on presumed income (from land)
     - based on land income
     - on rental income (annual rental value or capital value)
     - value of gross or net income
2. **Personal (or poll) tax**
   - on individual or household
   - on livestock
3. **Wealth and property tax**
   - based on area with adjustments
   - based on capital (market) value
   - based on land improvements

**Indirect Taxes:**

1. Tax on domestic trade (GST/VAT and turnover tax)
2. Tax on foreign trade (import duty and export tax)
3. Excise on specific marketed products
4. Cess on specific marketed products
5. Stamp duty

A major argument in favor of indirect taxes has been that they can generate significant government revenues and are relatively easy and inexpensive to administer. However, they can adversely affect efficiency and raise equity concerns. Land taxes can, arguably, raise efficiency and improve equity. But they often face strong vocal opposition, are hard to assess, and quite expensive to enforce and administer.


### Other Issues

The most significant tax which most commercial (including small-holder) farmers faces are the local ‘cess’ taxes collected by local authorities. Cess taxes, up to 5% of the farm-gate price, comprise one of the taxes permitted to local authorities.
under the ‘closed list’. In certain rural local authorities the only taxable economic activity is agriculture, and as the tax is withheld by traders, it provides local authorities with a relatively easy to collect source of revenue. Table 8 shows how the net result is a potentially heavy tax burden on the rural sector.

Table 8: A Comparison of average tax rates: urban vs. rural

<table>
<thead>
<tr>
<th></th>
<th>Small Farmer</th>
<th>Small Urban Business (incomplete records)</th>
<th>Small Urban Business (complete records)</th>
<th>Large Farmer</th>
<th>Large Urban Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Revenue</td>
<td>3,000,000</td>
<td>3,000,000</td>
<td>3,000,000</td>
<td>30,000,000</td>
<td>30,000,000</td>
</tr>
<tr>
<td>Net Income</td>
<td>1,500,000</td>
<td>1,500,000</td>
<td>1,500,000</td>
<td>7,500,000*</td>
<td>7,500,000*</td>
</tr>
<tr>
<td>Corporate Income Tax</td>
<td>-</td>
<td>35,000</td>
<td>33,000</td>
<td>2,250,000</td>
<td>2,250,000</td>
</tr>
<tr>
<td>5% cess</td>
<td>150,000</td>
<td>-</td>
<td>-</td>
<td>1,500,000</td>
<td>-</td>
</tr>
<tr>
<td>0.3% City Ser Levy</td>
<td>-</td>
<td>9,000</td>
<td>9,000</td>
<td>-</td>
<td>90,000</td>
</tr>
<tr>
<td>Total Tax Burden</td>
<td>150,000</td>
<td>44,000</td>
<td>42,000</td>
<td>3,750,000</td>
<td>2,250,000</td>
</tr>
<tr>
<td>Effective Average Tax Burden</td>
<td>5.00%</td>
<td>1.47%</td>
<td>1.40%</td>
<td>12.50%</td>
<td>7.50%</td>
</tr>
</tbody>
</table>

Assumes Gross Margin of 50% for all enterprises.

* Assumes large businesses are able to reduce taxable income by 50% because of deductions.

Source: FIAS Team calculations based on legislation and firm level interviews.

Table 8 shows that there is an ‘urban bias’. Even assuming a 50% gross margin, the average effective tax rate works out at 5% for small farmers vs. 1.4% or 1.47% for small urban businesses. Large businesses also benefit, by paying 7.5% average effective tax vs. 12.5% for large farmers.

A recent GSU report\(^\text{18}\) contends that “total crop cess collections for cashew represent on average a mere 3.54% of the turnover value of cashew nut at the farm gate price” and so is not particularly inequitable. This analysis rather misses the point as the impact of any turnover tax depends on (a) how it stacks up against other non-farm local business taxation, and (b) the profitability of the crop being taxed.

Some agricultural producers (for instance, cashew nut producers) have been lobbying for reductions in the cess by arguing that the tax imposes a high tax

\(^{18}\) See Andrew Young School of Policy Studies (2005)
burden and is horizontally inequitable, as it disproportionately singles out the production of specific crops for taxation (Fynn, 2004). It is inconsistent to apply favorable tax treatment to one crop over another.

The World Bank’s Diagnostic Trade Integration Study “DTIS” (2004) shows, persuasively, that the imposition of cess and/or export taxes is hindering the development of the fish, coffee, tea and cotton sectors. Further, based on cross-country experience, export taxes have generally failed to achieve industrial development objectives, and resulted in informal trade and frequently led to adverse distributional consequences as small-holders receive lower prices. The DTIS provides more details on export, and other, taxes which are hindering specific sectors in agriculture.

**Analysis of the Tax Regime**

*Ignoring the cess, the overall METR on capital for Agriculture is very low, at about 6%.* This result primarily reflects the immediate write-off for machinery and equipment, which actually gives rise to a negative METR (and therefore a tax subsidy). The METR on buildings in agriculture is also very low. This is due to the relatively generous write-off (20 years straight-line) relative to the economic rate of depreciation of agricultural buildings, which is quite low.

*Including the cess in the calculations changes things considerably, increasing the aggregate METR to over 23%.* The cess is levied at different rates on different crops on agricultural turnover. The calculations assume a 5% cess. As a gross turnover tax, with no deductions, the cess impinges quite significantly on the hurdle rate of return for a marginal investment.

**Recommendations**

- **Limit the ceiling on cess on ALL crops to 3% of farm gate price.**

While small businesses do pay overall less average tax than larger businesses (under the presumptive regime), it also shows that ‘urban bias’ exists. Urban businesses face lower average tax rates than agricultural ones. Given this, there is a strong argument to lower the allowable cess to 3%, which would be the equivalent of a 30% corporate income tax if the gross margin is 10%. This will require greater resource transfer from the national government to compensate, although there would hopefully be a supply response as farmers switched back into crops which have cess applied to them from those which do not. Finally, the sector specific ‘deals’ which certain associations have been able to negotiate (e.g. cashews) are inequitable and only serve to encourage other business associations to lobby for special treatment of their crops. This practice should stop going forward.
• **Apply the Skills Development Levy to agricultural firms.**

There is little evidential basis to exempt agricultural enterprises from the SDL. Many non-agricultural enterprises are also labor intensive (including food processing, such as cashews). The beneficiaries of this provision are likely to be larger agricultural enterprises. At the same time, the SDL is a tax on labor, the cost of which is shared by the employer and employee (Box 11).

• **Change the VAT status of agricultural inputs from ‘exempt’ to ‘zero-rated’**

The current ‘VAT exempt’ status of agricultural inputs (capital as well as seed, fertilizer, etc.) discourages their local production, as manufacturers are unable to claim back VAT paid on their own inputs. Changing their status to ‘zero rated’ would protect the consumer of the input (farmers) from higher prices while also removing the disincentive to manufacture locally.

• **Remove all remaining export taxes on agricultural commodities.**

While the motives for export taxes on unprocessed crops are understandable (to stimulate local value-added), their effect has been minimal so far on value-added activities and the instrument is ‘blunt’ in the sense that it results in informal trade and frequently leads to adverse distributional consequences as small-holders receive lower prices.

**Mining Sector**

**Summary of the tax and incentive regime**

The contribution of the mining and quarrying sector to GDP was 3.2% in 2004, total mineral exports were USD 656 million, an increase of 18.6% over 2003. Estimates suggest that mining will contribute more than USD 1 billion per year and contribute over 10% of the GDP.

The mining industry in Tanzania has recorded considerable growth over the past number of years, especially amongst large scale gold mining which has grown from a production of 323 kg of gold in 1997 to 46,219 kg in 2004, translating to exports of nearly $US 2 million in 1997 to $US 593.2 million in 2004, representing an increase of 29,550% in export value in 7 years.

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19 Impact Assessment and the mining Industry: Perspectives From Tanzania, Prof. Mwalyosi (2004).
Tanzania has considerable untapped natural resources, prospecting research estimates that some 130.2 million tons of gold reserves are present in Tanzania. Apart from gold there are significant reserves of gemstones, like diamonds, emerald ruby, sapphire and Tanzanite.

**Corporate income tax**

The standard rate of corporate tax (30%) applies in the sector.

The sector like all other sector benefits from an indefinite carry over of losses incurred. In addition expenditure occurred in one mine can be offset against revenue in another.

A cap on the fuel levy of a maximum of $US 200,000 per annum applies.

**Development Agreements**

In the past through individually negotiated “development agreements” with the Minister of Minerals and Energy a special mining license was awarded which effectively froze the fiscal regime at the point of the issue of the license for the entire period of the mining license, which is usually around 25 years.

These individually negotiated agreements differed depending on the time of signing of each agreement and were applicable to investors registered with the TIC.

Most agreements have most or all of the following elements:
- Immigration quota of up to 5 persons during the start-up period;
- Zero duty on all capital goods and equipment up to the end of the first year of production, thereafter 5% applies;
- Withholding tax of 3% on technical services to mining companies;
- A maximum cap on the fuel levy of $US 200,000 per annum;
- Initial capital allowance on capital equipment and machinery of 100%;
- Additional allowance of 15% is applied to un-redeemed development capital expenditure, not prospecting capital expenditure.
- No withholding tax on loan interest on foreign loans;
- Indefinite carry-forward of losses incurred.

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20 Tanzania Mining Act 1998, The Minister may enter into a development agreement granting a special mining license which guarantees the fiscal stability of a long term project by freezing the law in force relating to (royalties, taxes, duties, fees, etc) at the effect date of the agreement for the duration of the license.
There has been a move away from development agreements in Tanzania in favor of the general conditions offered in the tax law.

**Value Added Tax**

The standard VAT rate of 20% is applicable to limited services in the mining industry. Most mined minerals are exported from Tanzania in an unprocessed form and are therefore zero-rated and not subject to VAT.

In addition the mining industry benefits from special relief from VAT, whereby all equipment used solely for drilling, mining, exploration or prospecting activities can be imported free of duty by licensed mining, drilling, exploration or prospecting companies. Mining companies have to request permission for special relief prior to importation on an individual invoice for invoice basis.

**Royalties**

Royalties are charged at the netback value of minerals sold at the rate of 3% for gold and other minerals and at 5% for diamonds and other gemstones. A 0% royalty is applied to cut and polished gemstones.

**Surface Rentals**

A surface rental is payable by mines to the government at a rate of US$ 150/km2 per year.

**Withholding Tax**

Withholding tax on technical services to mining companies is levied at 5% to residents and 15% to non-residents.

Withholding tax on royalties, natural resource payments and dividends are charged at 10% for residents and 15% for non-residents.

There is no withholding tax on interest of Foreign sourced loans.

**Duties and Excises**

Zero customs duty on the importation by or supply to a registered licensed exploration, prospecting, drilling or mining company of goods and equipment in

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21 Market value of minerals (FOB) at the point of export
the exclusive use in exploration, prospecting, drilling or mining activities is applied in Tanzania.

Any capital equipment and machinery imported up to one year after the commencement of production, is imported duty free, thereafter a duty of 5% applies.

**Tax and incentive system in practice**

**General**

The design of a mineral taxation regime is crucial to ensure that government receives short term-revenues without jeopardizing the investment potential of long-term projects. The justifications for a specific mix of instruments and a separate tax regime for the mining industry are related to economic rent associated with the extraction of a scarce and finite resource such as minerals.

<table>
<thead>
<tr>
<th>Box 4: Economic Rent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic rent can be thought of as the difference between the market price of a commodity and the opportunity cost of engaging in supplying the commodity. Pure rent represents a surplus, financial return not required to motivate economic behavior and therefore could be taxed without influencing production decisions (i.e. without distorting the resource allocation). Even with all pure rent taxed away, resource owners would earn an acceptable return on their investment, so the resource allocation would be unchanged and the investment would go ahead. This is the theoretical argument underpinning the policy advice that governments can aim at taxing a large share of economic rent from mineral extraction. The opportunity cost of supplying a commodity is given by the supply price of investment, which is the return that is required to an investor to justify a decision to invest. This should be sufficient to cover the cost of exploration, development and production, the cost of capital and a risk premium. While all investment outcomes are unknown, ex ante, mineral extraction projects face an especially high degree of risk, especially related to geological, commercial and political risk. For a more risky project to go ahead an investor will therefore require a higher risk premium, which increases the supply side of the investment. The share of total return the government can tax without discouraging the investment from taking place (economic rent) will therefore be smaller the riskier the investor perceives the project to be. The investor’s risk premium will reflect both sovereign (political) and project (commercial) risks. The government can reduce commercial risk, for example, by making freely available exploration data or perhaps by financing exploration activities. Political risk can be reduced by strengthening macroeconomic and fiscal stability. This illustrates that there are actions the government can take to minimize uncertainty, which will reduce the supply price of investment thereby increasing the economic rent that can be taxed without discouraging the investment taking place.</td>
</tr>
</tbody>
</table>

*Source: IMF, 2001*

Obtaining the government’s share of economic rent can be achieved by using a variety and mix of tax instruments. The choice of tax instruments is crucial to a
successful regime. A mix of instruments which may generate the same amount of economic rent paid may have two different effects on the profitability and risk of projects. When selecting the optimal tax instruments the impact on the risk and profitability needs to be taken into consideration as well as the short and long term revenue collection needs of the government.

Table 9 shows how various tax instruments affect neutrality, investor risk, government risk and implementation difficulties.

<table>
<thead>
<tr>
<th>Tax Instrument</th>
<th>Neutrality</th>
<th>Investor Risk</th>
<th>Government Risk</th>
<th>Implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Efficiency</td>
<td>Stability</td>
<td>Project Risk</td>
<td>Loss</td>
</tr>
<tr>
<td>Fixed fee</td>
<td>-3</td>
<td>-3</td>
<td>-2</td>
<td>+3</td>
</tr>
<tr>
<td>Royalties</td>
<td>-3</td>
<td>-1</td>
<td>-1</td>
<td>+2</td>
</tr>
<tr>
<td>Corporate income tax</td>
<td>-1</td>
<td>+1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Progressive profits tax</td>
<td>+1</td>
<td>+3</td>
<td>+1</td>
<td>0</td>
</tr>
<tr>
<td>Resource rent tax</td>
<td>+2</td>
<td>+3</td>
<td>+2</td>
<td>-2</td>
</tr>
<tr>
<td>Production sharing</td>
<td>-1</td>
<td>+1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Paid equity</td>
<td>+3</td>
<td>-1</td>
<td>+3</td>
<td>-3</td>
</tr>
<tr>
<td>Carried Interest</td>
<td>+2</td>
<td>+3</td>
<td>0</td>
<td>+3</td>
</tr>
</tbody>
</table>

*Source: IMF, Primer on Mineral Taxation, 2001*

*Scores range from -3 < > +3, indicating how far the tax instrument (rows) serves the various goal of mining tax policy (columns).*

**Corporate income tax**

Mining tax regimes have steadily moved away from royalty taxes in favor of corporate tax which now dominates most fiscal regimes. Most countries include mining projects in the normal corporate tax regime, however in a number of developing countries the mining industry have different applicable corporate tax rates, some even differ by type of mine.
Table 10: Corporate Tax Rates for Mining Companies

<table>
<thead>
<tr>
<th>Country</th>
<th>Tax rate</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Botswana</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>Ghana</td>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Kenya</td>
<td>30%</td>
<td>(Resident companies 30%, non-resident 37.5%)</td>
</tr>
<tr>
<td>Malawi</td>
<td>30%</td>
<td>(Resident companies 30%, non-resident 35%)</td>
</tr>
<tr>
<td>Mexico</td>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>Mozambique</td>
<td>40%</td>
<td>(Mining tax 40% with a fifty % reduction to 20%, for a period of 10 years</td>
</tr>
<tr>
<td></td>
<td></td>
<td>after the start of production, national rate 32%)</td>
</tr>
<tr>
<td>Namibia</td>
<td>37.5%</td>
<td>Diamond 55%, other mines 37.5%, national rate 35%</td>
</tr>
<tr>
<td>Peru</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>PNG</td>
<td>35%</td>
<td>(for large mines and 25% for most other mines)</td>
</tr>
<tr>
<td>Tanzania</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Uganda</td>
<td>25 – 45%</td>
<td>(Mining companies 25-45%, national rate 30%)</td>
</tr>
<tr>
<td>Zambia</td>
<td>25%</td>
<td>(Copper and cobalt 25%, national rate 35%)</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>35%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Global Taxation and Mining Taxation in Developing Countries, Otto (2000) and Comparative Mining Tax Regimes, Price Waterhouse Coopers (1998).

Higher corporate tax rates usually apply in the mining industry, enabling countries to extract more economic rent from projects. These rates are not always flat rates but are often progressive - taking the nature of the industry into consideration. Progressive corporate tax rates allow the government to benefit from the upside of projects by applying an increased tax rate when mines are highly profitable. This is achieved by having a tiered tax rate, or formula based rate, linked to higher production prices, production volume, turnover or on the profit to sales ratio. Examples of such tax rates are found in South Africa and Namibia. However, such taxes are difficult to administer, don’t always correlate with the return on the project and, when the applicable tax rate is high, encourage corporate tax avoidance through careful tax planning and the use of transfer pricing.

Tanzania applies the standard flat national corporate tax rate of 30% in the sector, which compares favorably with competitive destinations in Africa. National tax rates in comparative developing mining countries have shown a steady decline, tax rates currently range between 30% - 35%.

The corporate tax rate in Tanzania has little effect on mining companies however, due to the concessions agreed to in a number of development agreements with some of the large mining companies. The 100% initial capital allowance, the
additional 15% allowance on un-redeemed capital, the carry-forward of exploration and prospecting costs and the indefinite carry over of assessed losses, results in most mines not paying tax at present with a likelihood of paying marginal or zero corporate tax in the future. That most mining companies are not currently paying corporate tax is not surprising, given the infancy of the industry. Most mines, even under a less generous tax regime, would be unlikely to be in a profitable situation so early in the life cycle due to the capital intensive nature of mining projects and the long pay-back period. The impact on corporate income tax receipts will be felt over the longer term.

Tanzania does not suffer from a high corporate tax rate and is therefore unlikely to encourage avoidance of corporate tax by mining companies in Tanzania. However, due to a relatively low tax rate and the unprofitable situation of most mines in Tanzania, Tanzania could be used as a country for “dumping profits” through transfer pricing to avoid paying tax in other higher taxed countries.

<table>
<thead>
<tr>
<th>Box 5: Transfer Pricing</th>
</tr>
</thead>
</table>

A global mining or petroleum company will have tax liabilities in many countries. This provides fertile ground for attempts to reduce the overall tax liability through transfer pricing and other means of tax avoidance. Through transfer pricing, a taxpayer seeks to minimize income and maximize deductible expenditures in high-tax jurisdiction and vice versa in low-tax jurisdictions. Some transfer pricing mechanisms that affect revenues are:

- The sale of export proceeds at below-market prices to an affiliated company located in a lower tax jurisdiction. However this is less of a challenge in the mineral sector, as the extracted mineral is a homogenous product with a transparent price.
- However, it can become problematic if firms make creative use of price hedging mechanisms perhaps involving transactions between related parties. It can be very difficult to assess if hedging instruments are used for transfer pricing purposes rather than for reducing price risk.

Measures to maximize expenditure deductions include:

- The provision by related parties of debt finance at above-market interest rates perhaps leading to highly leveraged projects.
- Claiming excessive management fees, deductions for headquarters costs, or consultancy charges paid to related parties.
- The provision of capital goods and machinery in leasing arrangements at above-market costs charged by a related party-lesser.
- If the mineral tax rate is above the standard tax rate, there may be an incentive to establish a domestic shell firm that will on-lend financing capital from related parties to the mineral firm giving rise to an interest deduction at a higher tax rate than is charged on the interest earnings in the shell company.

For most tax administrators, transfer pricing is an enormous challenge that can be very difficult to detect and prevent. Properly designing the tax code, though, is an important first step. At a minimum, tax legislation should include safeguards requiring that transactions between related parties be assessed on an arms-length basis, or perhaps that certain deductions be capped as a share of total costs.

Source: IMF, Primer on Mineral Taxation, 2001
Individual mines/projects within the sector are not ring-fenced, thus further reducing the effect of corporate tax. There is however, ring fencing of the mining industry prohibiting the deduction of expenditure of businesses outside of the industry against mining operations. The lack of ring-fencing also poses a possible additional problem relating to existing development agreements. Expenses of new mines (under old development agreements) can be offset against revenue of old mines (which are likely to be more profitable) enabling new mines to also benefit, indirectly, from older development agreements.

A large proportion of countries do not impose ring-fencing restrictions on mining projects, such as: Argentina, Bolivia, Canada, Chile, Ghana, Ivory Coast, Mexico, Philippines and Zimbabwe. The countries that do impose ring fencing, such as Peru and Papua New Guinea do so mainly due to both development agreements and the fiscal system applying to different mines.

The capital intensive nature of mines and the significant costs of equipment associated, especially in the early years of a project when setting up a mine, can have a severe impact on the measures of project profitability and investment returns. It is therefore common practice in the mining industry for governments to offer some sort of accelerated depreciation on capital equipment. In Tanzania an initial capital allowance of 100% is allowed, which is far higher than that in most other developing countries.

Table 11: Depreciation Rates in the Mining Sector: Comparisons

<table>
<thead>
<tr>
<th>Country</th>
<th>Depreciation rate</th>
<th>Base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>60%</td>
<td>Initial 60%, then 20% straight line thereafter</td>
</tr>
<tr>
<td>Botswana</td>
<td>10%</td>
<td>Straight line basis</td>
</tr>
<tr>
<td>Brazil</td>
<td>20%</td>
<td>Straight line</td>
</tr>
<tr>
<td>Chile</td>
<td>33.33%</td>
<td>Straight line</td>
</tr>
<tr>
<td>Ghana</td>
<td>75%</td>
<td>Initial 75%, then 50% declining balance thereafter</td>
</tr>
<tr>
<td>Indonesia</td>
<td>10%</td>
<td>Straight line</td>
</tr>
<tr>
<td>Mexico</td>
<td>10%</td>
<td>Straight line</td>
</tr>
<tr>
<td>Peru</td>
<td>20%</td>
<td>Straight line</td>
</tr>
<tr>
<td>PNG</td>
<td>150%</td>
<td>Declining balance over 7 years</td>
</tr>
<tr>
<td>South Africa</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>Suriname</td>
<td>25%</td>
<td>Straight line</td>
</tr>
<tr>
<td>Tanzania</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Global Taxation and Mining Taxation in Developing Countries, Prof. James Otto (2000) and Comparative Mining Tax Regimes, Price Waterhouse Coopers, 1998.

Indefinite loss carry-forward also helps reduce the corporate tax burden in the sector. Such treatment is relatively common amongst mining industries in other countries, such as Bolivia, Botswana, Chile, Ghana, South Africa, Sweden, Western
Australia and Zimbabwe. Other countries (Argentina, Bukino Faso, China, Ivory Coast, Philippines and Poland) limit the carry over to 5 years.

**Withholding Tax**

Withholding taxes on foreign services protect local services offered in the country. After the increase of the withholding tax on technical services from 3% to 15% for foreign companies, the rate is now more comparable to international withholding tax rates. A large proportion of developing countries charge withholding taxes, usually at 20% for foreign services (the rate applied in Chile, Indonesia, Ivory Coast, Kazakhstan, Uzbekistan and Zimbabwe).

Although Tanzania does not currently levy a withholding tax on the interest on foreign source loans many countries do in order to protect local banks and encourage local lending. Only South Africa, Tanzania, China, Greenland and Sweden do not. In countries which do levy withholding tax in this area, the rate ranges from 10% to 30%, with an average of 12% to 15%.

**Development Agreements/Fiscal Stability Clauses**

The development agreements negotiated in Tanzania with investors regarding the freezing of the tax regime for the length of life of the mine are common practice in the mining industry.
Box 6: Fiscal Stability Clauses

Given the nature of investment in mineral extraction – long term, large-scale and up-front – a particular concern for investors is to guard themselves against unforeseen changes to the financial premises of the project. Of particular concern are changes to the fiscal framework. One safeguard mechanism that is often sought by investors is the inclusion of a fiscal stability clause in the project agreement. While this to the government can seem an attractive and, in the short run, inexpensive way of minimizing investor risk, in the longer run it may have costs by limiting the government’s flexibility to set tax policy. This can be further exacerbated if the practice spreads to other sectors in the economy, potentially resulting in a large revenue loss and increased administrative costs.

Fiscal stability clauses come in different forms. One approach is to “freeze” the tax system at the time of the project agreement. However, if the general tax system is later changed, this will imply a special treatment of a particular taxpayer. This will add to the administrative burden, especially if a number of projects are each operating under different tax systems. Another approach is to guarantee the total investor take. In other words, if one tax is increased, this will be offset by a reduction in another tax (or in principle by paying a compensatory subsidy). This perhaps preserves better the integrity of the tax system. Still, it may be quite difficult in practice to agree on compensatory measures that can satisfy both government and investor, particularly when there is uncertainty about future exogenous variables that will affect the project outturn differently under different tax systems. There are also some stability clauses that are asymmetric: protecting the investor from adverse changes to the fiscal terms but passing on benefits of economy-wide reductions in tax rates.

Fiscal stability clauses are widespread, particularly in the petroleum sector. Of 109 countries surveyed in 1997, a majority (63 %) provided fiscal stability clauses for all fiscal terms.

Source: IMF ‘Primer on Mineral Taxation’ (2001)

Although legally possible, adjusting past agreements will only serve to reduce investor confidence and thus increase the political risk of future projects reducing the future revenue opportunity in the sector. In addition the mining industry in Tanzania is still in the early growth phases of development with significant unrealized future potential. There are current and future opportunities to adjust agreements and regimes as the economic rent increases through a reduction in political and business risk. Business risk has reduced drastically in comparison to when the development agreements were signed (far more information has been obtained on the extent and size of the deposits in the country).
Box 7: The Legality of Stabilization Schemes

It is generally agreed that in common law legal jurisdictions that the actions by one generation of law-makers cannot “bind” the hands of future law-makers. This is less true in some civil law, tradition nations. Thus stabilization is to some extent a legal myth as a subsequent group of law makers can change the law to effectively negate almost any stabilization scheme. However there is a strong inducement for subsequent governments not to do so as investor confidence will be weakened.

Source: Global Mining Taxation, Otto (2000)

The Tanzanian government has already made some significant adjustments to the tax law, by adjusting and eliminating some of the concessions offered in past development agreements. The additional allowance of 15% applied to unredeemed capital was recently removed and no longer applies. In addition the withholding tax of 3% on technical services has been replaced with a rate of 5% to resident owned companies and 15% to non-resident owned companies.

Value Added Tax

Most minerals are destined for export and are therefore zero rated for VAT. This coupled with the special relief status on imports means that in theory VAT has no effect on the sector. However, in practice due to the procedural and timing difficulties associated with obtaining special relief and the lengthy payment period of VAT refunds, the result is a significant amount of outstanding potential rebates in the sector which are impacting negatively on cash flows and are resulting in a relatively large additional tax burden on the sector. According to the industry, it is reported that the outstanding potential rebates in the sector which average between 6 months to 1 year for large mines, total in the region of $US 36 million. (It is important to note that these are potential rebates and not actual assessed rebates). Disputes by the TRA on potential rebates seem to result in a delay in all rebates, including those not under dispute.

If the special relief program worked effectively there would be no need to claim and pay rebates, however due to the time-consuming (taking approximately 2 weeks), laborious and impractical approval process of applying for special relief (applications have to be applied for ahead of time on a case by case basis by submitting individual pro-forma invoices from suppliers), operators generally restrict their special relief applications to large shipments only, relying on the refund process to claim the remainder of VAT owed.

Most countries prefer not to rely on the rebate system, which when inefficient can place a significant burden on the cash flows in the mining industry, which is highly capital intensive and heavily reliant on the importation of specialized equipment. Instead other systems like exemptions, deferment schemes, which don’t require the payment at the point of importation, are preferred. (Refer to the manufacturing sector of this report for more information on deferment schemes).

**Duties and Excise**

Registered investors benefit from paying no customs duties on the importation of capital goods and equipment up to the end of the first year of production. Therefore duties have very little impact on the mining industry.

Most countries globally have chosen to either eliminate customs duties altogether or have applied specific exemptions on a project basis, (based on a list of approved items or over a particular period of time).

**Royalties**

Over the past number of years globally there has been a general trend moving away from the royalties and towards other direct taxes such as profit based taxes. Although there are a number of countries which still apply royalties. Royalties are favored by governments as a means of compensating for extraction of a state owned resource. They are also preferred to corporate tax as they have a high compliance rate, a low cost of collection, and ensure an up-front revenue stream as soon as production starts.

Royalties can be applied in different forms, some are based on production volume, however most are based on the value of production. Values can be on a gross basis or net of costs. The royalties in Tanzania of 3% (gold) and 5% (diamonds) are progressive as they are based on market FOB value, are net of transportation and handling cost, net of the costs of smelting and refining and they are based on the market value of the mineral and therefore fluctuate based on market prices. In addition when compared to international benchmarks royalties are in line with the global averages of between 3% - 5%. Countries where royalties are not applied include: Canada, Chile, Greenland, Mexico, Peru, South Africa, Sweden and Zimbabwe. South Africa however, is currently considering introducing royalties on minerals, the current proposed royalty rates are also in line with global averages.

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23 Some Canadian provinces do impose profit sensitive mining taxes over and above the corporate income tax.
Table 12: Royalties: an international comparison

<table>
<thead>
<tr>
<th>Country</th>
<th>Gold</th>
<th>Diamonds</th>
<th>Base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>3%</td>
<td>3%</td>
<td>Net smelter return</td>
</tr>
<tr>
<td>Burkina Faso</td>
<td>3%</td>
<td>7%</td>
<td>FOB value</td>
</tr>
<tr>
<td>Brazil</td>
<td>3%</td>
<td>n/a</td>
<td>Gross Sales</td>
</tr>
<tr>
<td>China</td>
<td>4%</td>
<td>2%</td>
<td>Sales Revenue</td>
</tr>
<tr>
<td>Ghana</td>
<td>3% - 12%</td>
<td>3% - 12%</td>
<td>Gross value, depends on profit margin</td>
</tr>
<tr>
<td>Indonesia</td>
<td>US$ 225/kg</td>
<td>10%</td>
<td>Gold: prod. &lt; 2 000kg, Diamond: Sales rev. Prod. &gt; 2 000kg</td>
</tr>
<tr>
<td>Ivory Coast</td>
<td>3%</td>
<td>3%</td>
<td>Revenues less the cost of transportation and processing</td>
</tr>
<tr>
<td>PNG</td>
<td>2%</td>
<td>n/a</td>
<td>Realised FOB value</td>
</tr>
<tr>
<td>Philippines</td>
<td>2%</td>
<td>n/a</td>
<td>Market value of gross output</td>
</tr>
<tr>
<td>Tanzania</td>
<td>3%</td>
<td>5%</td>
<td>Netback value, Market value FOB</td>
</tr>
</tbody>
</table>

Source: Global Taxation and Mining Taxation in Developing Countries, Otto (2000) and Comparative Mining Tax Regimes, Price Waterhouse Coopers, 1998.

When setting royalty rates it is important to ensure that the rate is not too high, exceeding economic rent, as this will have a significant impact on the viability of a project and deter investment. Due to royalties being levied early on in projects, they affect the net present value of projects as they are levied early in the life of projects, before any profit is made.

In addition, royalties should be benchmarked against global rates and comparative countries, especially in the case of minerals such as gold and diamonds which compete on the global marketplace.

The impact of royalties is not just about the rate but also the base. Gross royalties are applied to revenues, with no deduction for operating or capital costs. As Box 4 explains, economic rents are revenues net of these costs. One approach to taxing economic rents is to impose a ‘resource rent tax’ which is in essence a straight cash flow tax (revenue less immediate expensing for all inputs, including capital, and no interest deduction). The problem with this is that cash flow can sometimes be negative. Another, economically equivalent, approach is to postpone the payment of royalties until all costs (plus a prescribed rate of return) have been recovered, then impose the rent tax on net income. One reasonable approach to royalties for example would be to impose a small (1-3%) gross royalty at the beginning and then a higher net royalty after capital costs have been recovered.
**Analysis of the tax/incentive regime**

Calculations were undertaken for mining with and without the royalty, and under the “old” regime which grandfathers incentives for existing mining companies and for the “new” regime which allows lower write-offs. Ignoring royalties, the overall METR under the “old” regime is slightly negative suggesting a tax subsidy at the margin. This is because of the immediate write-off of capital expenditures under this regime. Existing mines in Tanzania eligible for this treatment are able to continue to expense capital on mine expansions. The “new” regime, for new mines, provides lower write-offs for capital equipment which increases the overall METR to around 13%.

Including royalties in the calculations increases the METR quite a bit, to 22% for the “old” regime and 32% for the “new” regime. Royalties are imposed on gross sales, with no deductions, so they impinge upon the marginal return quite a bit. However, these royalty rates are not out of line with royalty regimes internationally. Moreover, there is some debate regarding the inclusion of royalties in METR calculations, and in particular their treatment as a “tax” in these calculations. An argument can be made that royalties are payments to the government as owners of the resource, and should not be treated as a tax in the traditional sense. This report provides METR calculations with and without royalties.

**Recommendations**

Since 1998 Tanzania has opened one gold mine per year, currently the country has mining investment worth over $US 1 billion and boasts 6 modern gold mines in operation producing 1,500,000 ounces of gold worth more than $US 400 million per annum. The mining industry has recorded considerable growth from a low base in 1994 and continues to expand and develop.

Although relatively little amounts of corporate tax, VAT and customs duties have been paid in the past, the mining industry has contributed both directly and indirectly to the economy of Tanzania in the form of (PAYE, skills development levies, national social security fund, development of roads, schools and housing and the purchase of local production) this economic impact should not be underestimated.

Due to the infancy of the sector and the high risks associated with the unknown potential of mining at the time special mining agreements were negotiated, generous incentives were offered. Looking forward however, the future growth potential of the sector is widely acknowledged and there is reduced risk associated with ‘second movers’. A reduction in risk increases the potential economic rent of projects enabling government to increase tax rates without negatively impacting on
investment decisions. There is therefore scope to tax future mining projects more in line with the generic tax regime as well as international best practice.

- **Apply the standard depreciation rates applicable in the tax regime to the mining sector and eliminate the 100% initial allowance**

The initial capital allowance is one of the main contributors to the low corporate tax burden in the sector. The mining sector going forward, should be treated in a similar manner to other sectors in this regard by eliminating the initial capital allowance and applying the already accelerated depreciation rate of 25% on mining equipment, as stipulated in the current income tax law.

- **Abolish special relief in favor of VAT deferment**

The special relief scheme is not effective in providing relief on the VAT on the importation of mining equipment. It has resulted in operators resorting to the usual channels of applying for rebates which has put a strain on administration and has resulted in a number of outstanding claims of considerable amounts. A deferment scheme should be implemented in order to reduce the cash-flow burden on operations and reduce the time and cost of administration of the current system.

- **Ensure that separate mining projects are ‘ring-fenced’**

In the case where development agreements and other standard fiscal regimes are in effect and apply to different projects in a country, individual mining projects should be ring-fenced in order to reduce the administration complications of calculating the applied tax rates to different projects undertaken by the same company. Ring-fencing should not act as an incentive for companies to develop additional projects, thereby benefiting from development contracts which were negotiated under different circumstances (different risks and opportunities).

- **Remove the cap on fuel levies**

This is a generous benefit to the sector but it is unclear why this sector benefits disproportionately.

- **Apply normal customs duties after the first year of production.**

Due to the high cost of capital and the negative impact on the feasibility and viability of projects they pose, especially in the prospecting and early operation stages, the relief on customs and duties should remain until the end of the first year of production. Thereafter remove the 5% duty and apply the standard rates detailed in the common customs tariff.
Manufacturing

The manufacturing sector in Tanzania has sustained high growth rates averaging 7% per annum in recent years, while continuing to account for around 8% GDP and 10% of merchandise exports. Despite the recent recovery in manufacturing, firms struggle to be competitive in particular due to infrastructure bottlenecks (power), high cost and lack of access to finance, poor customs and trade facilitation, and inadequate technology and skills upgrading. Manufacturing activities are concentrated in the areas of agro-processing and food, textiles and other light industry (furniture), and heavy industry (metals, cement, paints and plastics).

Summary of tax and incentives in the manufacturing sector

Corporate income tax

Manufacturing firms operate mainly under the standard tax regime:

- Income tax of 30% is levied on corporate profits, payable on a quarterly basis.
- Tax depreciation allowances for expenditure on plant and machinery by manufacturing firms: 50% on plant and machinery in the first year, and 25% (normal rate) in subsequent years.
- No limit on the carry forward of tax losses following start-up.
- Manufacturing qualifies as a priority sector under the Tanzania Investment Center which issues Certificate of Incentives, that include the following tax incentives:
  - VAT zero-rating on manufactured exports;
  - VAT deferment for imports of new capital equipment for manufacturing;
  - Income tax benefits such as: allowing interest deduction on capital loans; 100% capital allowance deduction in the first year of income.

Value Added Tax

VAT is charged at 20% but exports are zero-rated. VAT on capital goods is deferred at the time of import or purchase. A TIC certificate holder can apply to the Commissioner of Customs to extend this relief so that other goods can be considered as capital goods for a particular project. Businesses can claim VAT refunds if supported by an auditor’s certificate.
Export Incentives

The Duty Drawback Scheme enables exporters to apply for refund of import duty paid on inputs used to produce exports.

Export processing zones (EPZs) are available to both domestic and foreign investors that export at least 70% of goods produced. This is currently limited to "new export companies," thus excluding established exporters from benefiting (a complaint amongst manufacturers). Two zones are in Zanzibar (the Zanzibar Free Economic Zones Authority and Zanzibar Free Port Authority - see Zanzibar discussion below). The EPZ operating on the Mainland offers the following incentives to investors:

- Exemption from corporate income tax for the first 10 years; thereafter, a reduced tax of 25% (instead of the standard 30%).
- Exemption from withholding tax on dividends and interest for the first 10 years.
- Exemption from all taxes and levies imposed by local governments for goods and services produced or purchased in the EPZs.
- Exemption from potential foreign exchange control and restrictions.
- Exemption from pre-shipment inspection requirements.
- On-site Customs inspection in lieu of off-port inspection.
- Remission of Customs duty, VAT, and any other tax payable on goods purchased for use as raw materials, equipment, and machinery, or goods and services related to manufacturing in the EPZs (except motor vehicles, spare parts, and consumables).
- Provision of temporary visas at the point of entry to key technical, management, and training staff for a maximum of period of 30 days.

Additional incentives can be granted on a case-by-case basis (under section 20 of 1997 Investment Act). The tax holiday exemptions are not in line with international best practice on what makes for an effective and efficient incentive (see Section on Zanzibar).

The Tax and Incentive Regime in Practice

The capital-intensive segments of the manufacturing sector benefit substantially from the investment allowances of 50% on plant and machinery in the first year, and tax depreciation rate of 25% in subsequent years. However, firms consider the indirect or administrative costs of taxation to be excessive. Some of the key issues pertaining to the sector are discussed below.
Processing of VAT refunds

A risk-management system has been introduced to reduce the processing time of refund claims. Tanzania has adopted a VAT refund system based on the ‘gold’ status scheme, under which traders with good compliance histories are to obtain accelerated VAT refunds. ‘Silver’ status, and ‘non-gold-silver’ taxpayers receive progressively less preferential treatment. All refund claims are to be processed within the statutory 30 day deadline. With the exception of exporters, VAT refund claimants are required to carry-forward excess tax credits for 6 months.

Gold claimants are categorized as regular repayment traders which have not recorded any fraudulent offence over the past two years, and are eligible to receive a refund within 30 days. Silver claimants, (as well as gold ‘occasional’ traders), who have not met gold criteria by September 2004, receive a refund within 30 days for their first two claims, but the third claim triggers an audit by TRA. Non-gold-silver claimants include traders who are not gold-silver occasional traders, or whose supplies are non-zero rated, or silver claimants with irregularities in two consecutive audits. These are subject to an audit of every claim before receiving refunds.

In Pakistan, the implementation of this scheme (see Box 8), along with other recent reforms – such as zero-rating of supplies to about 85% of exporting sectors formerly filing for refunds – led to a drop in pending refunds from 56,000 to 3,500 between January and August 2005 (FIAS, 2006). The success of this system relies heavily on developing profiles for each taxpayer (an improved system would keep records of compliance history and audit results of all taxes, including VAT).

Nevertheless, delay in the payment of VAT refunds remains the norm. These funds represent tied-up working capital for firms, and cause cash-flow problems. Effectively, delays in refunds alter VAT from a tax on consumption to a tax on production. Refund claims particularly affect those firms that export or supply exempt sectors (such as mining). Industry representatives indicate that refunds are not repaid for extended periods throughout the sector (ranging from a few months to a few years), in particular when the claims are large. Also, while the law also stipulates that interest is payable to the taxpayer if claims are not repaid within 30 days, interest due is also not normally paid. Financial costs are further aggravated due to some firms resorting to borrowing from banks at high interest rates to maintain their cash flow.

Whereas the new procedures accord to best practice if applied consistently, in practice the criteria used for qualifying for the categories are not considered transparent to businesses. The main reason cited for the delays in refunding approved claims is inadequate budgetary allocation for payment of refunds in
TRA (due to short-term cash shortfalls, or lack of suitable forecasting and monitoring systems).

In addition, firms in the manufacturing sector report that every VAT refund claim is subject to verification prior to payment. This is contradictory to a system which is based on conducting risk-assessments. This reflects reluctance by the tax authorities to rely fully on a risk management approach to processing VAT refunds, perhaps doubting that this approach presents adequate safeguards in environment where there is a weak culture of paying taxes. It is believed that VAT evasion is widespread in the form of inflated refund claims and under-reported sales. However, not all verification activities are undertaken by the tax authorities. Under its VAT laws, every refund claim must be verified by an auditor registered by the Tanzanian national board of accountants and auditors.
Box 8: Application of “Gold” Status Scheme for VAT Refunds in Pakistan

Pakistan implemented a risk-management system in the late 1990s to improve the processing of VAT refunds, especially for exporters in the textile sector. The system was further improved, and basic computer applications were developed to provide information on traders’ compliance history, using information from the VAT, income tax, and customs administrations.

Under the scheme operating in Pakistan, refund claimants are categorized in three main groups: (1) “gold” for claimants exhibiting minimal revenue risk; (2) “silver” for moderate risk claimants; and (3) “others,” representing those of high or unknown risk. The table below outlines the type of criteria used in categorizing taxpayers. Gold refund claimants normally have their claims approved for payment, without a pre-refund audit, within 3-5 days. Silver claimants are assigned an upper refund limit, where claims not exceeding the limit are subject to a brief desk review and approval is given within 15 days. Post-refund audits are conducted at least once a year on two or three claims submitted in the past 12 months by gold and silver claimants. If the post-refund audits detect persistent inaccurate claims, the gold or silver status of a claimant is withdrawn.

Refund claims from taxpayers without gold or silver status are processed (paid or denied) within the statutory deadline. Claims are selected for pre-refund verification in the following circumstances:

- The claim is a first-time refund claim.
- The claim exceeds a value prescribed by the tax administration.
- The claim deviates from the regular refund pattern of the claimant.
- Previous claims have been rejected or reduced as a result of verification checks.
- The claimant has a record of poor compliance in relation to VAT and other taxes (e.g., non-filing, and late payment).

### Requirements to Qualify as a “Gold” and “Silver” Taxpayer

<table>
<thead>
<tr>
<th>Gold</th>
<th>Silver</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exporters with at least three years’ export history and net wealth exceeding a specified amount</td>
<td>Exporters with at least one year export history and net wealth exceeding a specified amount</td>
</tr>
<tr>
<td>Proper books of account for at least the last three years</td>
<td>Proper books of account for the duration of taxable activities (or three years, whichever is the lesser)</td>
</tr>
<tr>
<td>No evidence of fraud or significantly overstated refund claims in the past three years</td>
<td>Consistent pattern of export activities and products</td>
</tr>
<tr>
<td>History of accurate and timely tax remittance for all taxes and duties</td>
<td>History of accurate and timely tax remittance for at least the past 12 months</td>
</tr>
<tr>
<td>Bank certification that accounts are in good standing</td>
<td>No evidence of fraud or overstated credit claims in at least the past four refund claims</td>
</tr>
<tr>
<td>Records audited by the tax office for six of the past 24 months</td>
<td>Records audited by the tax office for three of the past 24 months</td>
</tr>
</tbody>
</table>

Source: IMF, 2005
**VAT refund issues are a common problem in many tax administrations**, in particular for exporters whose sales are zero-rated or firms that make large purchases compared to sales (usually new firms). Statutory deadlines for refunds are commonly 30 days, but vary between 24 hours in Peru to 90 days in France (though an administrative performance standard reduces this to 30 days). In many countries VAT refunds amount to over 40% of gross VAT collections (e.g. South Africa, EU, Canada), but less than 10% in most of Africa (IMF 2005b). Delays generally arise due to either (i) excessive fraudulent claims resultant from an ineffective tax auditing function in tax administration, or (ii) revenue constraints of government leading to reluctance or inability to process refunds.

**Many countries allow VAT refunds to be offset against other tax liabilities.** VAT refunds can be offset against other tax debts owed by the claimant (such as income tax), and in some countries against non-tax debts and customs duties. Some countries issue “tax credit certificates” which firms may use to pay other taxes (e.g. Uruguay). Offsetting arrangements require appropriate accounting systems that provide a consolidated and current view of taxpayer’s profiles across all taxes (see Box 9).

### Box 9: Offsetting VAT Refunds against other tax liabilities

VAT refunds should be offset only against other tax liabilities. It is administratively cumbersome to apply excess VAT credits to non-tax debts owing to the state. Second, as a general rule, VAT refunds should not be offset against anticipated tax liabilities (i.e., taxes assessed but not yet due for payment), given the negative effect that this offsetting may have on a taxpayer’s cash flow. However, if a taxpayer has a history of noncompliance (including failure to file income tax returns or pay amounts when due, or engages in other activities to avoid meeting tax obligations), the tax authority may consider offsetting even though amounts are not yet due for payment. Third, offsetting should be adopted only if a tax authority has established an adequate taxpayer accounting system and debt management infrastructure (i.e. integrated computerized accounting systems to provide a consolidated view of a taxpayer’s liabilities and entitlements across all taxes).

*Source: Extracted from IMF 2005b.*

**Approaches to tackling refund problems.** International experience suggests that, as adopted by Tanzania, pre-refund verification checks should be limited to high-risk claimants so that authorities can tackle VAT fraud. For example, countries such as Hungary, New Zealand, and the United Kingdom apply methods based on risk management principles.

Tanzania has also adopted the approach of deferring accounting for VAT in imports of capital goods until filing of the next return. Manufacturing firms complain that in practice the system is not implemented adequately, and that VAT is levied at customs and re-funds are subject to delays.
Another approach adopted in countries is zero-rating supplies to exporters (e.g. France). However, this creates breaks in the VAT credit chain. Zero-rating supplies to exporters effectively shifts the problem of controlling refund claims away from a small number of well-known exporters to an often larger and lesser-known group of suppliers.

An evaluation of different approaches (Table 13) shows that only the preferential treatment of good compliers achieves a reduction in administration and tax compliance costs, while at the same time accelerating refund payments for most traders and enhancing protection of the VAT revenue base. One drawback of the scheme, however, is that it tends to favor older established firms with established track records over new enterprises (but the effects of this can be mitigated if the tax administration complements the scheme with effective education and assistance programs for new enterprises).

Box 10. Key Features of a VAT Deferment Scheme for Imported Capital Goods

- The scheme is limited to registered VAT taxpayers who import large items of capital goods.
- Capital goods (both imported and domestic) are subject to the standard rate of VAT.
- Imports of capital goods by persons who are not registered VAT taxpayers are subject to VAT at the time of import. VAT is paid, as usual, before clearance of the goods.
- Importers of capital goods who are registered VAT taxpayers are permitted to defer accounting for the VAT liability until their next return is filed.
- In this return, the VAT applicable to those goods is reported as a VAT liability and, in the same return, the VAT input tax credit is claimed for the capital goods.
- If the importer is entitled to 100 percent input tax credit (equipment used exclusively in taxable activities) the VAT applicable to the importation, reported as a liability, will be completely offset by the corresponding input tax credit.
- The customs office is furnished with a copy of the VAT return to close their records of the importation.

*Source: IMF 2005*
Table 13: Evaluation of specific approaches adopted by countries to deal with VAT refund problems

<table>
<thead>
<tr>
<th></th>
<th>Reduces refund delays</th>
<th>Reduces number of claims</th>
<th>Enhances revenue protection</th>
<th>Reduces taxpayer costs</th>
<th>Reduces tax admin costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zero-rated supplies to exporters</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Invoice cross-checking</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>CPA certification</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Pref. treatment of good taxpayers</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Purchases through banking system</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>VAT bank accounts</td>
<td>No</td>
<td>No</td>
<td>Not proven</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>VAT deferment on imported capital goods</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: IMF, 2005b.

Payroll Taxes – Skills & Development Levy

A Skills & Development Levy of 6% of payroll costs is levied on employers under the VETA Act, 1994. The government set up an autonomous Vocational Education and Training Authority in 1995 to provide customized courses to meet training needs of employers. This is financed through a payroll levy of 2% on employers. The remaining 4% is a housing development levy.

Given the specific need for skilled labor in order to improve manufacturing sector competitiveness, an a priori expectation would be that manufacturing firms would welcome a scheme designed to increase skills. Yes many firms in this sector, especially those with large payrolls, regard the training levy scheme as a burden, often claiming it supports an ineffective public training system, and is being diverted to uses other than training. Also, the prevalent view is that only some workers benefit from the training yet all are contributing, thus leading to cross-subsidization\(^\text{24}\). Furthermore, since small employers are less likely to train staff (because they are less able to spare workers from their normal duties), the levy may be acting as a subsidy to large employers while being a tax on the smaller employers.

\(^\text{24}\) Although this does, as is the intention of such scheme, create an incentive for firms to send their employees for training.
In Tanzania, all employers consider the VETA payroll contribution as a tax which they bear. Who actually bears the burden of the tax, the employer or the employee, will depend on the elasticities of demand and supply of labor (See Box 11). In practice, in an already high cost environment, if the employer cannot pass on the costs to workers, they may face incentives to under-report workers, thus discouraging the creation of formal employment. Over 50% of manufacturing employment in Tanzania is on a contractual basis, perhaps as a result of this effect. In addition, employers face the entire administration burden of the SDL.
Box 11: Who Bears the Burden of Labor Taxes?

Taxes on labor (such as payroll taxes, personal income taxes and training levies) are often accused of being a ‘tax on employment’ and deterrent on employment expansion by firms. However, this is only true if it increases the costs to the employer. To the extent that the employer is able to pass on the costs of the tax to the employee, in the form of lower wages, the impact on the employers’ labor costs are ameliorated.

The diagram below illustrates a hypothetical labor market. The tax (t) on labor shifts the supply curve up, and less labor is both demanded as the price (wage) rises to $W^\wedge$. Employers bear roughly half the impact, being forced to pay an additional $W-W^\wedge$. Employees must accept a lower wage, $W^*$, and their wages fall by $W-W^*$. Both employers and employees lose surplus, and there is also a dead weight loss to the economy as a whole.

In a labor market characterized by an elastic supply (labor responds quickly to price changes by moving in and out of employment), producers are more able to pass on the ‘cost’ of a labor tax to their employees. In a perfectly elastic supply situation, all the costs of labor taxes are passed to employees.

Developing countries are often characterized as having elastic supply curves for labor, as there is little formal employment and no social security system to fall back on. In these circumstances the employees bear the majority of the burden of labor taxes. (Employers must still handle administration costs, which they may or may not also pass on to employees). However, labor markets are very fragmented and there may be a shortage of supply of skilled workers for example, which would make their supply relatively inelastic. Difficulties in hiring and firing workers also creates a more inelastic supply.

Source: Stiglitz (1986)
Internationally, skills levy rates generally range between 0.5-2% of payroll and often, smaller employers are excluded from the scheme. Usually, under levy-grant schemes such as Tanzania’s, grants are paid to firms conditional on criteria met once a systematic training approach is adopted. This encourages firms to act systematically in relation to their training programs. Examples of other countries which implement these schemes include South Africa and Hungary. See Box 12 for best practice in designing a levy-grant payroll scheme. In Singapore, under the Skills Development Fund, the number of firms benefiting from the fund more than doubled since 1991, and the number of workers trained tripled since inception (mostly on-the-job training, see Table 14).

**Box 12: Designing Payroll-Levy Schemes**

Several points of principle should guide the operation of payroll levy schemes, so that the benefit relation between levy payers and training beneficiaries is maintained. These include:

- Levies should be subject to periodic review
- Where possible, levies should vary across sector and industry to reflect differing skill composition of the labor force and training needs
- Training authorities should not venture into extraneous activities
- The range of training services and courses provided should reflect the range of employer needs
- Levies should be used to promote training by enterprises.

If governments are mainly concerned with upgrading the skills of the workforce, a levy-grant scheme can be implemented that is revenue neutral overall. All money collected by the government through a levy would be transferred back to firms – possibly after the government takes a small administration fee. Firms who train more would get back a larger proportion of funds. Under such a scheme, a firm would receive a grant not only on the basis of how much it trains, but also how much it trains relative to other firms in the economy - hence firms have an incentive to train more to keep pace with their competitors and get a larger grant. This initiative could also encourage small firms to train more. However, the drawback of putting in place such a scheme in a developing country context is similar to that of any other levy scheme - implementing such a scheme may be administratively difficult to do.

If implemented, these schemes should finance in-service and not pre-employment training. Firms are more likely to share in the cost of firm-specific training but less likely to share in the cost of general training. To the extent pre-employment training is general in nature, the burden of paying for that training should not fall upon firms. However, some countries have used a portion of the resources levied from firms to fund training authorities and public training centers which provide pre-employment training for unemployed youth and other marginalized groups. While this may be a socially justifiable objective in itself, it may not be the most optimal economically.

Table 14: Levy-Rebate Schemes: Examples from France and Singapore

<table>
<thead>
<tr>
<th>Scheme</th>
<th>Impact</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>The French levy-exemption system</em>. Dates back to 1925 aimed at providing incentives to promote both school-based vocational training and employer training. Composed of two parts: an “apprenticeship tax” and a “training tax” combining for over two % of payroll. Payment of taxes is due at end of year, unless evidence can be presented by employer that an amount equivalent to tax was spent on authorized training. VET schools receive employer grants on the basis of competition between providers.</td>
<td>These provisions have been increasingly utilized by employers. Amount of training tax not spent by employers and to be collected by the state was almost zero in the 1990s. Similarly only four % of the apprenticeship tax was not spent by employers and paid to state. Competition between providers of training – both public and private – ensures that training remains relevant to market demand.</td>
<td>Effective system in place for administering levy. Efficient tax collection mechanisms in place. Larger employers invest more heavily in training. Small enterprises (less than 10 workers) have not expressed an interest in participating and hence are exempt from the training tax. Training costs remain high and provision is not highly cost-effective.</td>
</tr>
<tr>
<td><em>Singapore Skills Development Fund</em>. Established in 1979 to provide incentives for the development of higher-level skills to support Singapore’s economic restructuring. All firms levied one % of payroll for low wage workers (those earning below S$1000/month). Firms can claim partial reimbursement on certified courses.</td>
<td>Number of individuals trained tripled since inception and number of firms benefiting from the fund has more than doubled since 1991. A significant portion of training is conducted on the-job.</td>
<td>Success partly due to excellent administrative capacity that allows tight selectivity in the offering of grants, growing local demand for training, strong network of industry based training facilities, and a policy that ensures that grants are linked to firms restructuring programs. Even though the program is aimed at improving skills of low-wage/low-skilled workers, small enterprises, where such individuals predominate, want to be exempted from the levy as they feel they do not benefit from it – less than 14% of firms with less than 10 employees avail of the SDF. Employers are also reluctant to use funds to train older workers (over 40 years).</td>
</tr>
</tbody>
</table>

**Customs Administration**

Customs assessments are carried out on all goods upon importation, including for TIC holders. Investors eligible for incentives apply to the Commissioner of Customs for approval. Investment incentives in the form of VAT deferment are given to capital goods and ‘deemed’ capital goods. The latter incentive is granted by a special task force in the Ministry of Finance.

While manufacturing firms, which rely heavily on imported inputs, acknowledge that there has been a significant improvement in tax administration in recent years, they continue to be concerned with the unequal enforcement of tax and customs policy. Firms believe that the negotiated granting of incentives on deemed capital goods creates potential for abuse and creates pressure to extend VAT exemptions to other imports.

The WTO valuation system was implemented in 2001. Yet, firms complain that ad hoc valuation and categorization by customs authorities leads lack of transparency and uncertainty. Customs authorities claim that there is a high level of non-compliance from businesses, and businesses acknowledge that some traders submit false invoices. But businesses also claim that Customs uplift the value of import declarations during the duty assessment phase, often referring to information on prior import values as a reference point. This system creates a cycle of non-compliance (as importers under-invoice) and uncertainty. A specialist valuation unit would contribute to addressing some of the valuation issues and increasing the level of certainty faced by businesses e.g. setting valuation policy, making decisions on special cases according to WTO Agreement on Customs Valuation (ACV) rules.

Continued progress toward simplified and lower tariff rates would help reduce the incentive to under-invoice and in turn reduce the friction between importers and customs on ‘up-lifting.’ In addition, the ongoing efforts to set up an audit system based on risk assessment and enhance the post-clearance audit and verification unit will help address some of these issues.

Exchange of information between tax and customs agencies for the purpose of verifying VAT returns and claims is critical since almost half of gross VAT revenues are collected at the border. In Tanzania, this flow of information is restricted to case-by-case requests. In some countries there is periodic transmission of routine data, and in others online access to customs data by tax officials is permitted (e.g. Singapore).
Export Processing Zones / Special Economic Zones

In January 2006, the Tanzanian Government submitted a Special Economic Zones Act (2006) and the Export Processing Zones (Amendments) Act, 206 to Parliament. Tanzania’s “Mini Tiger Plan” considers Special Economic Zones (SEZ) to be a key instrument for creating an improved environment for attracting local and foreign investment, facilitating expansion of employment opportunities, and attaining its economic growth targets.

Since the establishment of the mainland Tanzania EPZ Program in 2002, 7 developers and 9 operators have been granted EPZ licenses. At present, EPZs provide employment for about 1,600 people (down from 2,500 a year ago). The DTIS suggests that the legal and regulatory regime is broadly adequate and that the time and cost involved in obtaining an EPZ license are competitive with other comparator countries such as Kenya and Zambia.

But firms in EPZs do face several constraints such as access to power and water, and institutional constraints, including the lack of an on-site customs office in the largest EPZ (Millenium Park) and cumbersome reporting requirements to TRA and NDC. These and other factors have contributed to low occupancy of EPZs.

There is not scope within this report to provide a full analysis of the success or otherwise of the existing EPZs, or merits and demerits of the proposed draft EPZ and SEZ legislation. Assistance on these technical issues is available from the World Bank (including FIAS) and IMF (Fiscal Affairs Department) amongst others. However, international best practice shows that the most successful zones focus on the provision of adequate access to infrastructure (in situations where economy-wide provision is not feasible), streamlined customs procedures, and the use of SEZs as pilot areas for investment climate reform with streamlined business procedures and policies (including taxation) through sector practices. Tax incentives when offered as part of SEZs/EPZs risk undermining the tax system without generating sustainable growth and investment (see the Zanzibar section for a fuller description of the pro’s and con’s of various tax incentives).

Analysis

The manufacturing sector faces an overall weighted average METR on capital of about 15%. The main reason for this is the 50% initial investment allowance, which generates a METR of just under 4% for machinery and equipment. This lowers the aggregate METR significantly because of the importance of equipment in the capital structure of manufacturers. Manufacturing firms are then able to

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25 DTIS, World Bank,
write the balance of the capital expenditure off at a 25% declining balance rate, which is slightly higher than the economic depreciation rate for manufacturing equipment. This rate is reasonable, however, given the lack of inflation indexing.

**Administrative and Compliance Issues**

While the METR on capital in the manufacturing sector is relatively low, there is considerable qualitative evidence that there are some persistent administrative and compliance problems.

One problem discussed above is the delay in the processing and granting of VAT refunds for exporting firms or firms undertaking major capital expenditures. While there has been improvement on this dimension, discussions with the private sector indicated that some problems persist. A related issue concerns delays in receiving imported capital inputs due to administrative difficulties at the border.

These types of administrative problems can be thought of as acting as a type of “implicit administrative tax” on businesses activity, a tax that does not generate revenue for the government but nonetheless impinges upon the rate of return to capital employed by businesses. It is extremely difficult to quantify the importance of this “implicit administrative tax” on investment, though anecdotal evidence suggests that it is very important.

We can, however, present some illustrative calculations using the METR framework to show how important this “implicit administrative tax” can be. It should be stressed that these calculations are illustrative only and are meant simply to exemplify how administrative delays can impinge upon capital formation.

The illustrative calculations are undertaken for an investment in machinery in the manufacturing sector and presume that VAT refunds are delayed for one year and that administrative problems delay production by six months. It should be stressed that these are not meant to be indicative of the delays that take place in practice – while this is not out of line with anecdotal statements provided by some businesses, we have no hard data to back this up – but rather merely to illustrate the impact of delays of this magnitude on the “implicit administrative tax” and subsequently on the METR on capital.

The calculations are shown in Table 15. The first column reproduces the METRs from Table 7 for a large manufacturer. The METR on equipment is 3.8% and the aggregate METR is 15.3%. The second column provides the illustrative calculation of the impact of the “implicit administrative tax” on manufacturing equipment. Under the illustrative assumptions – a six month delay in production and a one year delay in the VAT refund – the METR on equipment increases
seven-fold, from 3.8% to 26.7%; the overall weighted-average METR increases from 15.3% to 26.03%.

These calculations illustrate how important the hidden, or “implicit administrative tax” can be and emphasize the importance of good administration. As indicated above, from a statutory policy perspective the Tanzanian tax system is in solid shape. A sound statutory regime is an important step towards creating an environment conducive to investment and growth. Further improving tax administration to reduce the “implicit administrative tax” is the equally important next step.

Table 15: Illustrative Calculations of the Impact of Administrative Delays on the METR on Capital: Manufacturing

<table>
<thead>
<tr>
<th></th>
<th>No Administrative Delays</th>
<th>Administrative Delays</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>3.8%</td>
<td>26.7%</td>
</tr>
<tr>
<td>Buildings</td>
<td>27.7%</td>
<td>27.7%</td>
</tr>
<tr>
<td>Land</td>
<td>1.6%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Inventories</td>
<td>21.9%</td>
<td>21.9%</td>
</tr>
<tr>
<td>Total</td>
<td>15.3%</td>
<td>26.0%</td>
</tr>
</tbody>
</table>

**Recommendations**

- **VAT**: Increase transparency in risk-profiling system by publishing criteria.

The current system of risk-profiling should be maintained in order to deal with refund-related fraud. To increase transparency, clear criteria for qualifying for gold, silver and non-gold-silver tiers should be established and published. Commitment to timely refund processing could be re-affirmed by publishing service standards in taxpayers’ charters and similar documents.

- **TRA must secure sufficient funding to process VAT refunds.**

The TRA needs to improve its capacity to secure the required appropriation for refunds and adequately budget for refunds.

- **Consider offsetting VAT refund claims against other tax liabilities.**

Procedures could be streamlined to allow the TRA to offset any refund payment against any tax arrears. Currently, the income tax law does not allow income tax related information to be provided to the VAT administration. This system would require an integrated taxpayer accounting and debt management system to be in place. Integration of the Tanzania Inter-bank Settlement System (TISS) and Integrated Tax Administration System (ITAX) systems could allow payment of
VAT refund through the TISS system and the debiting of the taxpayer’s account in ITAX system by the finance department.

- **Separate skills levy of 2% from development levy for increased transparency.**

- **Finance in-service rather than pre-employment training.**

Enable firms to receive a grant on the basis of how much it trains, whether through programs of in-house training or through recognized training centers. Alternatively, under payroll tax exemption schemes, payment of levy is due at end of year unless evidence can be presented by the employer that an amount equivalent to tax was spent on authorized training (e.g. France).

- **Enable more systematic exchange of information between tax and customs agencies.**

A systematic approach to information exchange will enable verification of VAT returns and claims.

- **Set up a specialist valuation unit**

This unit would set valuation policy and make decisions on special cases according to WTO Agreement on Customs Valuation (ACV) rules.

- **Focus EPZ and SEZs on the provision of infrastructure and reducing compliance costs, rather than on tax incentives.**

The proposed extension of Economic Processing Zones and Special Economic Zones in Tanzania could act as catalyst for increased investment. However, learning from international experience, it is important that EPZs and SEZs focus on the provision of infrastructure and one-stop-shop facilities for administration/taxation/customs – rather than a vehicle for tax incentives.

**Tourism**

In 2005 Tanzania tourism industry is estimated to contribute 4.3% of GDP and generate 292,590 jobs, while the broader direct and indirect travel and tourism economy contributes an estimated 9.7% of GDP and 672,608 jobs. Travel and tourism demand is expected to achieve 11.5% real growth in 2005\(^{26}\) and 4.8% real growth per annum between 2006 and 2015.

\(^{26}\) World Travel and Tourism Council, Tanzania Country Report 2005
The World Travel and Tourism Council (WTTC) provides empirical research on the price competitiveness of countries, as illustrated in Table 16. Regarding price competitiveness Tanzania does not compete favorably when compared to its immediate competitors, ranking as the second highest in the region.

Table 16: Regional Comparison of Tourism Competitiveness

<table>
<thead>
<tr>
<th>Description</th>
<th>Tanzania</th>
<th>Rwanda</th>
<th>Burundi</th>
<th>Kenya</th>
<th>Uganda</th>
<th>South Africa</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase Price Parity</td>
<td>26.81</td>
<td>6.54</td>
<td>7.63</td>
<td>22.52</td>
<td>7.48</td>
<td>10.46</td>
<td>26.41</td>
</tr>
<tr>
<td>Tourism Price Index (2004)²⁷</td>
<td>26.11</td>
<td>12.17</td>
<td>17.85</td>
<td>22.28</td>
<td>12.73</td>
<td>5.5</td>
<td>29.19</td>
</tr>
</tbody>
</table>

Summary of the tax and incentive regime

**Corporate tax**

Corporate tax in the tourism industry is applied at the standard rate of 30%.

The industry benefits from generous initial capital allowances of 50% on plant and machinery used for providing services to tourists and plant and machinery fixed in a hotel or lodge.

Rates of depreciation applicable to capital equipment in the tourism industry are: vehicles (37.5%), furniture, fixtures and equipment (12.5%) and buildings (5%).

**Value Added Tax**

The standard rate of 20% is applicable to certain services in the tourism industry. The transportation of tourists by road and air are exempt from VAT, with the exception of taxi cabs and rental cars. Transportation by boat and the chartering of boats are not exempt and are subject to VAT at the standard rate.

The VAT law also makes provision for the exemption of specific tourism related services such as: tourist guiding, game driving, water safaris, animal or bird watching, park fees and tourist charter services.

²⁷ '0' shows the least price competitive country and '100' represents the most price competitive country. It is computed using the Hotel Price Index (room rate per night in current (2004) US dollar) and adjusted for Purchasing Power Parity.
Although air services are exempt from VAT the services provided by a tour operator or travel agent in arranging and booking the service are not exempt and are subject to VAT at the standard rate.

All services performed in Tanzania are considered as local services and are subject to VAT at the standard rate.

**Incentives**

The tourism industry benefits from a number of investment incentives for qualifying investments\(^{28}\) associated with initial capital allowances and customs and duties relief.

Registered investors benefit from zero customs and excise duties on the importation of capital equipment vehicles and machinery used in the establishment, expansion and renovation of a tourist business. This includes vehicles used in tour operator businesses and most fixtures, fittings, machinery, equipment and operating equipment used in the construction, establishment and renovation of a hotel or lodge.

**Duties and Excises**

Registered investors in the tourism industry receive extensive benefits relating to the zero rating of customs duties and excise, as aforementioned.

Recently gazetted East African Customs Union\(^{29}\) legislation also provides additional benefits to all licensed hotels enabling them to import capital equipment and also operating equipment at a zero rate\(^{30}\) provided these items are engraved, printed or marked with the hotel logo.

Currently no customs relief on vehicles and other equipment is provided to small tour operators investing less than the TIC investment threshold\(^{31}\). In the customs law vehicles are not differentiated by sector but are based on the common customs tariff.

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\(^{28}\) Minimum investment capital for foreign investors of US$ 300,000 and US$ 100,000 for local investors

\(^{29}\) East African Cummunity Gazette, 15th September 2005

\(^{30}\) Washing machines, kitchen ware, cookers, fridges and freezers, air conditioning systems, cutlery, television sets, carpets, cutlery, furniture, linen and curtains.

\(^{31}\) Footnote 28 refers.
### Malt Beer, Wine, Spirits, Cigarettes, Fuel, Vehicles

<table>
<thead>
<tr>
<th>Product</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malt Beer</td>
<td>243 Tsh/l</td>
</tr>
<tr>
<td>Wine</td>
<td>780 Tsh/l</td>
</tr>
<tr>
<td>Spirits</td>
<td>1158 Tsh/l</td>
</tr>
<tr>
<td>Cigarettes</td>
<td>3970 Tsh</td>
</tr>
<tr>
<td>Fuel</td>
<td>146 Tsh/l</td>
</tr>
<tr>
<td>Vehicles*</td>
<td>10%</td>
</tr>
</tbody>
</table>

*above 2 000 cc

Source: Tanzania Revenue Authority Website

### Visas

Tourist visas are required by most countries and range from $20 to $50.

### Service Charge

A discretionary service charge of 5% is included in the amount billed at a hotel or lodge.

### Airport Taxes

A variety of taxes are levied in relation to air travel, airport departure taxes are levied at $20 for international travel and $2 for local travel.

### Tax and Incentive Regime in Practice

#### Corporate Income Tax

The corporate tax rate applied to the tourism sector is on par with competitive destinations in Africa.

Due to the highly capital intensive nature of the tourism industry, the ongoing need to upgrade assets, the initial capital allowance of 50% and the indefinite carry over of assessed losses, corporate taxation has little impact on hotels and tour operators in the Tanzania, including large and well established operators.

The application of allowable expenses relating specifically to fuel and telephone are not being consistently applied in the sector. These items are subject to interpretation by TRA officers and tend to vary by sub-sector and even within sub-sectors depending on the individual officers interpretation.

#### Value Added Tax

Some of the services provided by the tourism industry are exempt from VAT (transportation, tour guiding, game drives and charter services) whilst other services are subject to VAT at the standard rate (tour operator commissions / mark-up, accommodation and food and beverage). When different services with different VAT rates are bundled together in packages this increases the complexity of compliance, management and monitoring of the payment and submission on VAT.
This complexity also facilitates the possible manipulation of revenues and costs associated with each revenue source.

Tanzania is at a distinct competitive disadvantage from price competitiveness perspective relative to countries in the region and other competitive destinations, due to the tour brokering service not being regarded as an export service. Most countries in the region either zero rate the entire tour package (Zambia and Rwanda) or the tour brokerage / mark-up portion which is generally defined as an export service in the region and in other international long-haul competitive destinations (South Africa, Botswana, Rwanda, Kenya, Mauritius, Thailand and Australia).

The standard VAT rate of 20% applicable to certain services in the tourism industry in Tanzania is considerably higher than Tanzania’s main tourist competitors (Kenya 14%, Botswana 10%, Namibia 15% and South Africa 14%, as well as most other countries in the region, which averages around 17%). The different treatment of VAT by competitor countries is having a negative effect on the tourism industry in Tanzania, which is at a distinct price disadvantage caused by the high VAT rate.

Tanzania’s main competitor Kenya has followed the trends adopted in Europe and other countries by applying a lower rate of VAT to all hotel and restaurant services:

- Africa: Kenya (standard 16%, reduced 14%)
- South America: Chile and Columbia allow the deduction of VAT on all services provided to foreign tourists;
- Europe: Belgium (Standard: 21%, Reduced: 6%), France (Standard: 19.6%, Reduced 5.5%), Greece (Standard: 18%, Reduced: 8%), and Ireland (Standard: 21%, Reduced: 13.5%), Portugal (Standard 21%, reduced 5%

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32 A reduced rate of 14% applies to all restaurant and hotel services, Kenya VAT ACT (CAP.476) 2004, First Schedule Part 2.

33 HOTREC updated on 1 June 2005
Box 13: IMF Debate on the treatment of VAT in the tourism sector

The key economic point is that the ability of tourists to substitute between services offered by different countries can quite plausibly imply highly elastic demand for services that are broadly the same in different countries. This high elasticity points to a lower tax rate. This argument applies most obviously to facilities—palm-fringed beaches, for instance—that are much the same in different countries. Where facilities are genuinely unique, however, the same consideration will point to a high rate, naturally implemented as an excise or entrance fee.

A strong case can thus be made for setting a low tax on generic tourist services, perhaps even at a zero rate. Or, to discriminate between less elastic domestic demand and more elastic foreign demand, tax might be rebated to non-residents (as with hotel tax in Canada): this, of course, is potentially troublesome to administer.

At the same time, there are arguments against taxing generic tourist services at a low rate. The first is the administrative: multiple rates [within a sector or system] complicate administration and compliance, and create opportunities for abuse. The second is that there is a coordination problem: the elasticity of demand for tourist services offered by any particular country may be much greater than that for the services offered collectively (regionally). While the service offered by any particular game park is unique, for example, that offered by game parks in general is much more so. Thus, all countries could gain by collectively agreeing to raise the tax rate applied. This argument points to regional coordination. Finally, to the extent that such services are purchased by foreigners, who presumably appear in policy makers’ objective function with a lower weight than do their own nationals, the social loss from raising taxes on these goods will be reduced: taxing foreigners is always attractive.

Ebrill, Keen, Bodin, and Summers, The Modern VAT, IMF, 2001, p. 120.

The industry claims that complimentary stays and familiarization trips are being raised as revenue generating items by the TRA and subjected to VAT at the standard rate. In the tourism industry these items are usually treated as costs and are either raised at cost price or are not raised at all. If the intention is not to allow VAT to be claimed on complimentary stays then these items should be exempt from VAT, like other discretionary marketing expenditure such as entertainment, which is usually exempt. An alternative would be to have strict guidelines regarding what promotional trips are allowable. Governments should encourage operators to help promote tourism and not discourage promotion and marketing through such an interpretation.

Box 14. Benefits of tourism marketing

The British Tourist Authority estimates that every £1 of government spend on tourism marketing results in £25 spend on tourism. If the government were to receive 25 per cent of tourism spend in taxes, the government’s return on investment would be over 600 per cent.

Kenya for example encourages operators to market and promote the country by zero rating familiarization and promotional trips undertaken by overseas tour operators. They also stipulate certain guidelines to avoid abuse thereof by stating that the tour has to have the support of the department of tourism and must be conducted in conjunction with local associations and is in accordance with a predetermined written itinerary.\(^{34}\)

Tanzania treats the transportation of tourists differently to a number of other countries in the region. Some countries have chosen to exclude the transportation of tourists when exempting transportation of passengers from VAT. Both Namibia and Uganda explicitly exclude the transportation of tourists, while Rwanda’s exclusion is more implicit by stipulating that the exemption only applies to vehicles with a capacity of 14 passengers or greater, which effectively excludes most tours in Rwanda which are generally small high-end groups. South Africa has recently included a clause in the VAT law which excludes game drives from this exemption.

Tanzania also excludes other specific tourism services, such as tourist guiding, game drives and tourist charter services. The only country in the region which, like Tanzania, has an explicit definition referring to the exemption of the transportation of tourists is Kenya. Other than these two countries this is not a common practice in the region, where the trend is more to reduce the number of exemptions in the industry, especially as it adds complexity to the compliance, monitoring and administration processes. This exemption in effect also provides little to no benefit to operators especially considering that VAT cannot be claimed on any inputs when purchasing, maintaining, operating and running vehicles which has a greater impact in a country like Tanzania where VAT is also levied on fuel. Although the exemption of transportation does help improve the competitive nature of Tanzania by bringing down package prices this is outweighed by the costs associated with collection and compliance.

The service associated with the booking of air charter and scheduled air services by tour operators and travel agents is subject to VAT at the standard rate. In most other countries the exemption from VAT on air travel is usually applicable also to the commissions and most recently in South Africa also on the service fees associated with the booking and selling of the air travel. In effect in Tanzania this results in an increase in the cost of the ticket to the consumer placing additional pressure on travel agent and tour operator margins. This matter has been discussed with the TRA by the travel agent industry but has not been resolved. The current situation seems to be that most travel agents have de-registered for VAT in order to avoid paying VAT on their services.

Most hotels add a discretionary service charge of 5% onto the hotel bill. According to the industry, it is the position of the TRA that this amount should also be subject to VAT. In most countries where service charges are discretionary or are statutory (Zambia (10%), Malawi (10%)), VAT is not levied on this amount.

The industry mentioned that on the occasion when a VAT refund was due difficulties are generally encountered when trying to recover refunds, which are delayed.

**Incentives**

A large number of registered investors with a Tanzanian Investment Certificate, investing in hotels/lodges and tour operator businesses have received substantial relief from customs duties on vehicles and capital equipment invested in new tourism projects and expansions. All operators we spoke to who benefited from this relief mentioned that they did not encounter any problems when applying for this relief. This has resulted is a reduction in overall capital costs which has improved the profitability and long-term viability and competitiveness of tourism businesses. In addition a reduction in customs duties also helps reduce the project cost, increase the return on investment and place less pressure on pricing. These investors continue to benefit when undertaking approved expansions and refurbishments.

Local operators mentioned that they had difficulty with the compliance process in order to register as an investor with the TIC. Documentation such as detailed business plans and other information were required which they were generally unable to comply with without requiring external assistance. The complexity and cost associated with applications was mentioned as a deterrent and stumbling block for local businesses.

**Duties and Excise**

Import duties have a large impact on the tourism industry especially on vehicles, equipment and machinery used in the tourism industry, these items are usually imported from Kenya, South Africa or Dubai.

In the past smaller hotels and lodges below the TIC certificate threshold did not receive any import duty concessions when importing capital and operating equipment. The recent adjustment to the East African Customs Union law will also provide considerable relief to these operators.
Currently no customs relief on vehicles and other equipment is provided to small tour operators investing less than the TIC investment threshold\textsuperscript{35} which provides an additional burden on these operators and places them at a competitive disadvantage in comparison to larger operators. Considering that the tour operator industry in Tanzania is already dominated by a select number of large operators, who have the advantage of better quality of vehicles, access to finance, economies of scale and experience, this will likely lead to a failure of a number of smaller, largely locally owned tour operators in the future. Such treatment of taxation which adversely affects the development of small to medium sized operators in a fragile industry like tourism should be avoided.

<table>
<thead>
<tr>
<th>Box 15: Fragility and high failure rate of small tourism businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>The tourism industry is volatile due to the ease and frequency</td>
</tr>
</tbody>
</table>

Excise duties on beer, wine, spirits, cigarettes and fuel can contribute to making a tourist destination costly. In Tanzania excise duties are low in relation to other regional competitors.

<table>
<thead>
<tr>
<th>Table 17: Excise Duties in the Region</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country</td>
</tr>
<tr>
<td>---------</td>
</tr>
<tr>
<td>Tanzania</td>
</tr>
<tr>
<td>Rwanda</td>
</tr>
<tr>
<td>Uganda</td>
</tr>
<tr>
<td>Zambia</td>
</tr>
<tr>
<td>Kenya</td>
</tr>
</tbody>
</table>

Source: Customs and Excise and government departments of Tanzania, Rwanda, Uganda, Zambia and, Kenya.

Departure Tax

Departure taxes in Tanzania are in line with the average for the region.

\textsuperscript{35} $100 000 for local investors and $300 000 for foreign investors.
Table 18: Departure Taxes: Rwanda in comparison with the region

<table>
<thead>
<tr>
<th></th>
<th>Rwanda</th>
<th>Botswana</th>
<th>Mozambique</th>
<th>Kenya</th>
<th>Tanzania</th>
<th>Malawi</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20</td>
<td>$20</td>
<td>$20</td>
<td>$20</td>
<td>$20</td>
<td>$20</td>
<td>$30</td>
<td>$20</td>
</tr>
</tbody>
</table>

General

A large proportion of operators mentioned that there is a marked improvement in the way in which the Tanzania Revenue Authority has conducted their business over the past few years. Operators find TRA officers far more approachable and reasonable and open to discussion and negotiation regarding interpretation of the law.

Operators mention that Tanzania Revenue Authority seem to have limited understanding of the tourism industry and sometimes try and apply specific rulings which are contrary to accepted industry practice resulting in a difference in interpretation regarding: operating expenses, capital expenses and the packaging and pricing of goods and services.

Analysis of the tax/incentive regime

The overall METR on capital in the tourism sector is low, at just under 15%. The most important reason for this is the generous 50% investment allowance. For machinery and equipment the balance is written-off at a relatively higher 37.5% declining balance rate, which is substantially higher than the economic rate of depreciation.

However, it should be noted that there is substantial variation within the tourism industry. For example, small tour operators not eligible for a TIC certificate must pay duty on imported vehicles at 25%. This generates a METR on vehicles in excess of 70%.

Recommendations

The tax system applicable to the tourism sector is conducive to stimulating and encouraging growth, through large initial capital allowances, import duty relief and VAT exemptions.

Our recommendations focus mainly on simplifying the VAT system and helping to bring the VAT system in line with Tanzania’s main regional tourism competitors to help improve Tanzania’s competitiveness in the region.

- Simplify the VAT system by applying VAT to all tourism and transport services.
Simplify the current VAT system by applying the standard rate to all services provided by the tourism industry including tourism services and tourism transport. We do not recommend adjusting the definition of export services so that the tour operator service / commission is zero rated, as this would further increase the complexity of the application especially in the case of overseas tourist packages. Other countries where this system applies have large discrepancies in the interpretation and application of this law which is very difficult to monitor and easy to manipulate due to its complexity. A better alternative would be to simplify the application of taxes by standard rating all products. A more broadly applied VAT, at a lower rate, would benefit this sector and others. This leads directly to the next recommendation.

- **Investigate the feasibility of reducing VAT rate to the average in the region around 17%, or apply a lower VAT rate to the tourism sector specifically.**

Tanzania’s VAT rate is well above other regional competitors and should be adjusted, possibly to the regional average of 17%. This would move Tanzania’s VAT rate more in line with its main tourist competitors (South Africa, Botswana, Namibia, and Kenya who are all at 14%) or competitors should be encouraged to increase their VAT rates in line with Tanzania. The tourism sector provides a good example of why such a reduction deserves serious consideration as it feeds directly into the price competitiveness of the destination.

- **Encourage organized promotional trips by refraining from raising costs as revenue and applying VAT.**

Promotional trips should be treated as a cost, where costs are incurred and raised the VAT should be able to be claimed back by operators, thereby effectively making promotional trips zero rated. In order to control promotional trips we recommend that promotional trips need to be organized in conjunction with associations and approved by the Tanzania Tourism Board or the Ministry of Tourism.

- **Refrain from applying VAT to gratuities charged.**

- **Exempt travel agent commission from VAT.**

- **Evenly apply the incentives focused on the imports of tourist vehicles and equipment and machinery across the sector.**

Small tour operators are at a distinct disadvantage when compared to other small tourism business and compared to large registered TIC tour operators. We recommend that all tour operators be allowed to import vehicles on a duty free
basis based on approved projects and subject to operating a licensed tourism business. Further measures could be taken to ensure that this relief is not abused.

**Financial Sector**

*The Tanzania financial system is diverse but concentrated in commercial banking and very small in relation to the economy.* It comprises 21 banks; nine non-bank financial institutions; two pension funds that invest in financial assets; 14 insurance companies; 63 exchange bureaus; 650 functioning savings and credit co-operatives; several hundred micro-finance organizations and a fledgling stock exchange.

*The financial sector as a whole is sound with lending concentrated mainly in high growth sectors of the economy.* The last two years have witnessed remarkable progress in financial sector development, albeit from a low base. The system is liquid, well-capitalized, profitable, has good asset quality, and resistant to shocks. In terms of these indicators, Tanzania also compares favorably to other countries in the region. However, Tanzania’s bank credit to the private sector remains modest, partly because of increased sales of liquidity paper for sterilization purposes.

**Summary of the tax/incentive system**

**Corporate Income Tax**

*Banks and Insurance Companies*

Banks and insurance companies pay the standard 30% rate for corporate income tax. Commercial banks primarily earn revenue from the purchase of government securities and international exchange transactions. Business lending currently represents under half current assets.

*Pensions*

The IMF Financial System Stability Assessment in 2003 called for reform of the over-taxed pension system, specifically that pension contributions should become tax exempt. The system has duly been reformed to an ‘E/T/E system’, where-by pension contributions (from both employers and employees) are tax exempt, pension fund returns are taxed as normal, but pension payments are exempt from PAYE. This is an interesting system, which does not conform to what to considered ‘international best practice’ and yet has some merits (Box 16).
Box 16: The Taxation of Pensions

Under standard international practice for private pensions, the return on the savings directed into the pension plans is in effect exempt from taxation, consistent with basing the taxation system for these earnings on consumption rather than income taxation. Arguments in favor of this tax-preferential treatment are that it ensures that pensioners have an adequate standard of living in retirement and need to rely less on public pension plans, and that it encourages saving. This outcome could theoretically be achieved by either exempting the contributions that fund the plan and the current investment return on the saved assets, then imposing tax on the entire value of the fund when it is withdrawn (the “E/E/T” structure); or by taxing the contribution at the time it is made, but then exempting the return and the payout from the fund on maturity (the “T/E/E” structure). Under limiting assumptions, the two approaches will yield the same final benefit in present value terms.

If taxing the principal amount but in effect exempting the return (as in best international practice) is ultimately to be adopted for retirement savings, this leaves the decision whether to exempt the contribution on the way in or the benefit on the way out. Practical considerations other than the timing of government revenues point toward using the E/E/T model. While equivalent in present value terms (if tax rates do not change) to T/E/E, the incentive to obtain a current income tax deduction is likely in practice stronger than the promise of a deduction or exemption in 20 or 30 years.

*Source: International Monetary Fund: Fiscal Affairs Division*

Pension contributions by both employer and employee are 10% each, against an average of 3-7% in the region and internationally. The relatively large contributions (despite their tax deductibility), combined with the low returns generated, make the current pension arrangements unpopular with employers. Workers deem the annuity paid upon retirement too small, and this has led to cases whereby workers nearing retirement age ask to be terminated so that they can claim a lump-sum payment of their portion of contributions to the fund.

*Value Added Tax*

All financial business activities are VAT exempt. It is common for tax regimes to exempt some, or all, financial services from VAT, largely because it is difficult to determine what is the ‘value added’.

Where Tanzania differs from other countries (in the region and internationally) is that financial services firms receive exemption from VAT on capital imports.

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36 In Zanzibar and Uganda the figures are also 10% and 10%, while it is 5% and 5% respectively in Kenya
**Withholding taxes**

Banks are required to withholding taxes on branch profits paid to non-resident banks (10%); dividends (10%); management/professional fees for non-resident services (10%); non-resident contractual fees (10%) and interest payments (10%).

Insured parties are required to withhold 5% of premiums paid to non-resident insurers. This is most relevant to domestic insurers seeking re-insurance from overseas. Unlike Kenya and Uganda Tanzania does not impose withholding taxes on the commissions of insurance brokers or agents.

**The Tax / Incentive Regime in Practice**

In August 2003 the IMF released its ‘Financial System Stability Assessment’ (FSAP) for Tanzania. Partly in response to this the GoT have completed a comprehensive second generation Financial Sector Reform Program, to be implemented in 2005/6. The Assessment concludes ‘the overall tax system does not appear to limit financial sector development at present’. This statement still holds for Tanzania.

**Banks**

Excess liquidity, in part created by strong aid inflows, creates a buoyant market for government debt. The result is that banks are profitable, but not primarily as a result of lending to the private sector. The challenges in this sector pertain to regulation and competition rather than taxation.

That banks can import capital duty and VAT free, *is an unusually generous benefit.*

**Insurance / Pension**

The reform of the tax treatment of pensions, following the FSAP, is welcome as it removes a burdensome tax regime. However, the specific exemption from corporate income tax for the National Social Security Fund (NSSF) appears inequitable and inconsistent.

The 5% withholding tax on overseas insurance (mostly re-insurance) is a slight cause of complaint by the sector, but seems to have been accepted. In effect, many local insurers share the cost of this with their re-insurers abroad.
Other Issues

Leasing (operating or capital) provides a very useful way for low-income countries to increase investment. A capital lease (where the lessee owns the asset) is a form of secured lending. The current leasing market in Tanzania is small but several of the commercial banks are actively looking to expand leasing activities.

Box 17 outlines some of the lessons learned from the development of the leasing market in emerging economies. A key issue is how to tax leases, in terms of import duties on the capital, depreciation allowances and the application of VAT.

Financial services are exempt supplies under the second schedule of the VAT Act, 1997, and capital goods are VAT exempt, following recent amendments to the VAT Act. However, the VAT Act provides that leasing of goods is a taxable supply, and a problem arises over the practical application and interpretation of these provisions, as well as distinguishing between operating leases and finance leases for VAT purposes. There seems to be differing opinion within TRA on the application of VAT on finance leases, and how banks should go about charging VAT. As a result some of the major banks have run into VAT problems (and liabilities), and these issues are still unresolved. The major problem being the manner of charging VAT on finance leases. Legally, the 'credit' portion of the finance lease should be exempt. In so far as leasing of capital goods is concerned, the issue is not relevant. The problem remains with leasing of non-capital goods.

It is international best practice to treat capital leases equivalently to a similar transactions structured as a loan to purchase an asset (when the interest payments would not be subject to VAT).\textsuperscript{37} \textit{Equal treatment would help stimulate the capital leasing market in Tanzania.}

\textsuperscript{37}While it is true that VAT-registered businesses would be able to credit these VAT payments; (a) not all businesses are VAT registered, (c) some firms are engaged in Vat exempt activities (such as transport), and (b) it creates a cash flow problem, especially for small businesses.
Box 17: International Best Practice on Taxation of Leasing

In April 2005 the International Finance Corporation published a document on best practice regarding how to expand the leasing market. The highlights are:

Incentives for the leasing sector, if any, should be moderate as the over endowment of preferential tax treatments on leasing may cause distortions in domestic markets, and ultimately a negative effect on the general financial sector. The main reason to provide preferential treatment should be to increase domestic investment, and not stimulate the leasing sector.

The report provides the pros and cons of removing VAT on the import and/or sale of equipment intended for leasing. The tendency is to either make all steps VAT-able or VAT-exempt, rather than a mix, in order not to break the VAT-chain.

With capital lease payments the IFC recommend that “There should be a level playing field in terms of the tax effects of domestic credit offerings and leasing should not be disadvantaged against other forms of credit.” Therefore, the interest portion of capital lease payments should be VAT exempt, as are interest payments for normal bank loans (see Figure 3).

In terms of deductible expenses against revenue, again, IFC recommend a level playing field vis-à-vis a traditional loan (used to purchase an asset). i.e. that both the depreciation and interest component of lease payments are deductible for income tax purposes. In terms of depreciation, IAS-17 is clear on whether the lessee or the lessor can claim ownership for a capital or operating lease (and the definition of these two terms). It is possible (but not advisable) to offer more favorable, accelerated, depreciation rate for leased vs. traditional procured assets.

The capital gains tax of 10% in Tanzania for residents and 20% for non-residents is unique in the EAC. Neither Kenya nor Uganda has a capital gains tax, but in Rwanda capital gains are treated as normal income.

**Analysis of the Tax Regime**

*With an overall weighted average METR on capital of just under 29%, the financial sector bears one of the highest marginal tax burdens on capital of the sectors studied.* This is the case for one reason – the VAT. As financial services are exempt from VAT, this means that banks do not charge VAT nor are they able
to claim input credits for the VAT paid on much of their inputs. Thus, banks can bear a heavy effective sales tax burden on their physical inputs. The resulting indirect tax on bank inputs is what generates the high METR on capital equipment in the financial sector illustrated in Table 7.

This is moderated to some extent in Tanzania by the VAT exemption provided on capital imports at the border. We were not able to obtain information on the share of capital inputs employed by banks that bear VAT. The calculations in the table arbitrarily assume that half of the equipment purchased by financial institutes bear VAT. If, on the other hand, it is presumed that all capital equipment is imported VAT free (none of the equipment purchased by financial institutions bear VAT), then the resulting METR is substantially lower:

<table>
<thead>
<tr>
<th>Item</th>
<th>METR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>-39.6%</td>
</tr>
<tr>
<td>Buildings</td>
<td>17.4%</td>
</tr>
<tr>
<td>Land</td>
<td>1.3%</td>
</tr>
<tr>
<td>Inventories</td>
<td>21.7%</td>
</tr>
<tr>
<td>Total</td>
<td>-0.1%</td>
</tr>
</tbody>
</table>

In this case the METR on equipment in financial services drops to almost negative 40%. This indicates the provision of a substantial subsidy at the margin. This very low rate absent the VAT is due to the immediate write-off of equipment available to the financial sector and the imposition of a lower city levy (0.1% rather than the 0.3% imposed on other sectors). As a result, the aggregate METR on the financial sector absent the VAT on capital inputs is close to zero %.

It should be noted that there are many subtleties of the tax system as it relates to this sector that cannot be captured by the METR methodology. In particular, structured financing and the ability of financial institutions to easily move money, and book loans, between jurisdictions is a well known problem in this sector. Moreover, physical capital accounts for a very small share of the total assets of the banking sector, the bulk of which consists of financial assets.

**Recommendations**

- **Clarify the tax treatment of leasing transactions.** Specifically:
  - The VAT Act needs to state clearly that capital leasing is classified as a financial service, exempting associated interest payments from VAT;
  - Provide guidance on VAT treatment throughout the chain – from supplier to the lessee;
  - Clarify the allocation of the capital allowance under both capital and operating leases;
• Harmonize the application of withholding tax within the East African region to promote cross border leasing.
• Allow for leased assets to qualify for capital allowances as provided for under the Income Tax Act and by the TIC.

These reforms would make capital leases comparable to loans, which is consistent with international best practice. If the depreciation allowance is granted to the lessor rather than the lessee (some commentators argue this would stimulate the market), it is important to put in place a ‘sunset clause’ (say five years) so that the incentive is not indefinite.

• **Require the financial sector to pay VAT on capital imports.**

Banks and other finance houses have successfully argued that as their services and products are VAT exempt, they should be able to import capital VAT free in order to avoid paying VAT as a turnover tax. However, it is standard practice that the financial sector faces this problem. VAT is often one of the few ways in which the financial enterprises pay tax to government. (Banks are very adept at booking revenues overseas to avoid income tax liabilities).

• **Equalize the rate of capital gains tax to 10% for residents and non-residents.**

This will help stimulate corporate finance activity and investment from neighboring countries. In the longer term, integration of the EAC markets would benefit greatly from a uniform capital gains tax, which will require agreement amongst the EAC members.

**Small Business Sector**

Some estimates put the informal economy at 60% of GDP\(^{38}\). Three associations (at least) represent informal sector operators:\(^{39}\)

- VIBINDO: an umbrella organization registered in 1995, which in 2004 had 284 group members and about 30,000 individual members.
- Tanzania Small Industrialists Society (TASISO);
- Tanzania Food Processors Association (TAFOPA).

These associations receive support from the Small Industries Development

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\(^{38}\) For comparison, the informal economy is estimated at 36% in Kenya, 42% in Mozambique, and 45% in Uganda (Scheider, 2004).

Organization (SIDO), and from donor agencies. Increasingly, the associations are voicing their demands and are also being consulted more often in policy formulations. Recently, the Government of Tanzania has introduced a small and medium enterprise development policy.40

‘The Informal Sector Roadmap Study for Tanzania’ (2004) finds (p. 45) that a multiplicity of taxes and levies represent major constraints on small enterprises. Thus, the recent rationalization of the presumptive regime and abolition of ‘nuisance’ taxes at the local level are significant recent steps to encourage firms to join the formal economy. However, complicated, lengthy and unpredictable procedures and regulations, rent-seeking (bribery), as well as poor infrastructure, unfair competition etc also contribute to explain why many small entrepreneurs prefer to stay informal. Small businesses face proportionately higher time and financial costs to comply with administrative requirements and therefore may not see any benefit of joining the tax net. Reforming the tax regime is therefore one of several measures required to increase formalization. Nevertheless, the narrow tax base in Tanzania suggests that the tax environment encourages expansion of the informal economy.

**The Small Business Tax Regime in Practice**

The overall tax burden is compounded by other levies and fees at the central and local levels which tend to be significant for small business, and the benefits of which are not apparent. Under the small tax regime, businesses below the turnover threshold of TSH 20 million are required to pay a presumptive tax based on four brackets. This regime harmonized the corporate income tax and the stamp duty previously due. The current system is flexible and allows small businesses the option to pay a flat payment if no records are kept, or a percentage of turnover plus a smaller flat payment if some records are kept. Payments are due on a quarterly basis.

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Table 19: The Presumptive Regime in Tanzania

<table>
<thead>
<tr>
<th>Turnover</th>
<th>Tax Payable where Incomplete Records are kept</th>
<th>Tax Payable where Records are kept</th>
</tr>
</thead>
<tbody>
<tr>
<td>TSh 0 - 3,000,000</td>
<td>TSh 35,000</td>
<td>1.1% of the annual turnover</td>
</tr>
<tr>
<td>TSh 3,000,001 - 7,000,000</td>
<td>TSh 95,000</td>
<td>TSh 33,000 plus 1.3% of the turnover in excess of TSh 3,000,000</td>
</tr>
<tr>
<td>TSh 7,000,001 - 14,000,000</td>
<td>TSh 291,000</td>
<td>TSh 85,000 plus 2.5% of the turnover in excess of TSh 7,000,000</td>
</tr>
<tr>
<td>TSh 14,000,001 - 20,000,000</td>
<td>TSh 520,000</td>
<td>TSh 260,000 plus 3.30% of the turnover in excess of TSh 14,000,000</td>
</tr>
</tbody>
</table>

Source: Tanzania Revenue Authority.

Small (and medium) taxpayer administration is managed by the Domestic Revenue Department (DRD). Regional and district tax offices monitor compliance of small (and medium) taxpayers through a geographically based block management system. Under this system, business areas are divided into ‘blocks’. Block management teams carry out the functions of registering, assessing, collecting and accounting for tax revenue collected.

The narrow tax base in Tanzania suggests that the tax environment encourages expansion of the informal economy. Some estimates put the informal economy in Tanzania at 60% of GDP\(^41\). Rationalization of the presumptive regime and abolition of ‘nuisance’ taxes at the local level are significant recent steps to encourage firms to join the formal economy.

Small businesses face proportionately higher time and financial costs to comply with administrative requirements and therefore may not see any benefit of joining the tax net. The overall tax burden is compounded by other levies and fees at the central and local levels which tend to be very significant for small business, and the benefits of which are not apparent.

The ‘block management system’ attempts to deal with the poor compliance culture amongst small businesses. However, the direct and frequent interaction between tax officials and taxpayers raises risks of abuse of the system. Clear separation of tax assessment and collection functions by officials could help reduce some of these risks. This approach should be appropriately balanced with measures to encourage voluntary compliance through systematic education and outreach programs.

\(^{41}\) For comparison, the informal economy is estimated at 36% in Kenya, 42% in Mozambique, and 45% in Uganda (Scheider, 2004).
The Presumptive Regime

There are currently approximately 100,000 active small taxpayers who contribute only about 2% of total revenue from income tax and VAT. In contrast, about 286 large taxpayers (turnover above TSH 10 billion) contribute 68% of revenue, and less than 10,000 medium taxpayers contribute 30% of revenue (TRA in IMF, 2005b).

The presumptive regime in Tanzania is one of the more sophisticatedly designed systems in the region. Different groups of taxpayers are categorized in the four bands depending on estimates of average turnover for particular trades or professions. The system is based on generally low tax rates and provides flexibility to small businesses of different record-keeping abilities. It also provides an incentive to keep records, which is good management practice, and is rewarded by a lower average tax burden. However, about 70% of presumptive taxpayers registered with the TRA do not keep proper records, despite the fact that this results in a higher average effective tax rate (Table 20).

<table>
<thead>
<tr>
<th>Box 18: Presumptive Taxes in the Region</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Rwanda provides an option for all businesses with a turnover of less than RWF 20 million (= TSH 39.8 million) to pay either a 4% presumptive turnover tax or the regular CIT of 30% on profits.</td>
</tr>
<tr>
<td>• Uganda impose a small business tax on a sliding scale basis which is equal to a maximum of 1% of turnover on businesses with a turnover up to 50 million Ugandan shillings (USD 27 000);</td>
</tr>
<tr>
<td>• Zambia has an automatic presumptive tax system of 3% of turnover for small business with an income not exceeding ZK200 million (USD 51 000)</td>
</tr>
</tbody>
</table>

Source: FIAS (2005)
International experience suggests that tax regimes for small businesses should be as simple as possible. Simplifying tax regimes should go hand in hand with developing the capabilities of small businesses. The objective of a simplified system is not revenue collection but to encourage businesses to register with tax authorities and formalize. This objective needs to be carefully balanced with maintaining justifiable administrative costs of collection and compliance undertaken by revenue authorities.

The presumptive regime in Tanzania, while well designed, still exhibits the following anomalies:

- The system is regressive as non-record-keepers are more likely to lack the capacity to keep proper accounts. While the system is thus designed to provide an incentive to keep records, its success hinges on proper outreach and education so that small businesses can better understand the benefits of keeping records and graduating to the record-keepers system.

- For ‘non-record keepers’, the system is not consistently progressive. For example for a firm with a turnover of TSH 1 million, the effective tax rate is 3.5%, whereas it is only 1.4% for a turnover of 7 million.

Table 20: Small Business Tax Regime: Average Effective Income Tax Rates

<table>
<thead>
<tr>
<th>Bands</th>
<th>Turnover (TSH mn)</th>
<th>Total Tax Payable (TSH)</th>
<th>Avg. Effective Tax Rates (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Records</td>
<td>No Records</td>
</tr>
<tr>
<td>TSh 0 - 3,000,000</td>
<td>1</td>
<td>11,000</td>
<td>35,000</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>22,000</td>
<td>35,000</td>
</tr>
<tr>
<td>TSh 3,000,001 - 7,000,000</td>
<td>4</td>
<td>46,000</td>
<td>95,000</td>
</tr>
<tr>
<td>TSh 7,000,001 - 14,000,000</td>
<td>5</td>
<td>59,000</td>
<td>95,000</td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>72,000</td>
<td>95,000</td>
</tr>
<tr>
<td>TSh 14,000,001 - 20,000,000</td>
<td>7</td>
<td>85,000</td>
<td>95,000</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>110,000</td>
<td>291,000</td>
</tr>
<tr>
<td></td>
<td>9</td>
<td>135,000</td>
<td>291,000</td>
</tr>
<tr>
<td></td>
<td>10</td>
<td>160,000</td>
<td>291,000</td>
</tr>
<tr>
<td></td>
<td>11</td>
<td>185,000</td>
<td>291,000</td>
</tr>
<tr>
<td></td>
<td>12</td>
<td>210,000</td>
<td>291,000</td>
</tr>
<tr>
<td></td>
<td>13</td>
<td>235,000</td>
<td>291,000</td>
</tr>
<tr>
<td></td>
<td>14</td>
<td>260,000</td>
<td>291,000</td>
</tr>
<tr>
<td></td>
<td>15</td>
<td>293,000</td>
<td>520,000</td>
</tr>
<tr>
<td></td>
<td>16</td>
<td>326,000</td>
<td>520,000</td>
</tr>
<tr>
<td></td>
<td>17</td>
<td>359,000</td>
<td>520,000</td>
</tr>
<tr>
<td></td>
<td>18</td>
<td>392,000</td>
<td>520,000</td>
</tr>
<tr>
<td></td>
<td>19</td>
<td>425,000</td>
<td>520,000</td>
</tr>
<tr>
<td></td>
<td>20</td>
<td>458,000</td>
<td>520,000</td>
</tr>
</tbody>
</table>

Source: FIAS Team calculations based on information from TRA
• The system is inconsistent and inequitable with respect to Personal Income Tax, which has an initial tax-exempt band for total income less than TSH 960,000. Under the presumptive regime, businesses in the bottom band (turnover below TSH 3 million) that do not maintain records are required to pay TSH 35,000 irrespective of their actual turnover. An exempt band for small taxpayers, introduced in 2001 by the TRA, was abolished in 2003 to improve taxation of the informal sector. The reason is that surveys have shown that about 90% of small taxpayers have annual turnovers of less than TSH 6 million. An exempt band would imply that the majority of small businesses would be outside the tax net. Internationally, most presumptive regimes have two thresholds: below one level businesses are not taxed, and above another threshold they enter the standard tax system. If an exempt band is re-instituted to increase equity between tax systems, it would have to be carefully weighed with the objective of formalizing businesses.

• The exit threshold for the presumptive regime of TSH 20 million is inconsistent with the VAT threshold of TSH 40 million. However, an exit threshold that is too high undermines the standard tax system and allows too many businesses to benefit from the special regime. Any realignment of the thresholds must ensure that the rates applied to the TSH 20-40 million band are not too low so as to make the special regime too attractive relative to the standard regime. One of the objectives of special regimes should be to give incentives to businesses to graduate to the standard regime over time (other measures can also encourage graduation, see Box 18). In addition, a voluntary opt-in to the standard regime should be encouraged.

**VAT registration for Small Businesses**

Small businesses below the TSH 40 million turnover threshold are not required to register for VAT. Voluntary registration is allowed for businesses whose taxable turnover is below the registration threshold but only at the discretion of the Commissioner for VAT. The registration threshold was increased from TSH 20 million to TSH 40 million in 2004 in order to remove inactive/low-yielding taxpayers, and to focus administrative resources on ensuring better compliance from a smaller taxpayer base. The numbers of VAT registrations fell by 9,000, indicating a large proportion of potential VAT taxpayers in the TSH 20-40 million bracket (though less significant in terms of revenue). Of the remaining VAT registered taxpayers, excluding the Large Taxpayers Department, about half were opting to stay in under the voluntary registration provision. This also points to the potential interest in voluntary registration, currently requiring government clearance on an individual basis.
Non-registration creates breaks in the VAT chain resulting in small businesses not being able to claim back VAT on inputs. Small businesses therefore may suffer a substantive VAT burden from staying out of the VAT net. Those businesses that are registered are required to submit VAT returns on a monthly basis, significantly adding to the administrative burden of small businesses and of the TRA. In many countries, small businesses are only required to file returns on a quarterly or bi-annual basis.

**Outreach**

In Tanzania, small businesses complain about the lack of knowledge regarding tax compliance and recording requirements. Education programs and seminars organized by the TRA have not been effective enough in reaching out to this sector. This outreach function should be undertaken by the Small Business Tax Units (SBTU) that are planned to be established at each regional income tax office. SBTUs will operate under the block management system administered by the Domestic Revenue Department. The SBTUs will be responsible for the administration of small business taxation, including assessment, collection, accounting, and related activities. In addition, they are to assume a taxpayer education and sensitization function.

In many countries, tax administrations assist taxpayers to understand their tax obligations and entitlements. In particular, support is given to new businesses and potential taxpayers that are in the informal and who may not be fully aware of the tax registration requirements. Some countries provide a “small businessman’s kit” to small businesses that register with the revenue authority for the first time for this purpose. Such efforts lowers tax administration costs in the long run and also contribute to portraying a positive image of the tax authorities.
Box 19: Reaching out to Small Taxpayers

**The role of Revenue Authorities.** Revenue administrations have undertaken activities to make potential taxpayers aware of the general concept of taxation and why they should pay tax. For example, efforts to make compliance easier for taxpayers have included publishing pamphlets and creating web pages giving information on tax laws, rules and procedures and changes; organizing seminars and workshops for taxpayers, providing assistance to taxpayers in filling up tax returns, looking up their accounts to see how much they owe and clarifying doubts on legal and procedural matters; setting up telephone hot lines to answer questions; appointing floor walkers to assist taxpayers waiting in queues; and keeping tax offices open for longer on days when there are filing deadlines.

**The role of private sector Small Business Associations.** Small business associations can pursue the progressive regularization of small enterprises and promote the managerial and administrative upgrading of member firms. Representative associations aim to reduce the actual and perceived costs of regularization through the provision of technical assistance in the form of direct administrative services, such as accounting, payroll, and tax management.

The Italian artisan association, CNA, contributed to the rise of a dynamic small-scale industry in the Emilia Romagna region after the Second World War. The association buffered the impact on small businesses of the fiscal, accounting, and labor legislations by mediating with the public authorities the interpretation and the enforcement of these regulations, and, more importantly, by providing administrative (accounting, payroll, fiscal counseling) business development services and production-targeted (producers’ consortia, industrial sites, innovation centers) activities. These enabled small businesses to comply with the formal regulations and led to the regularization of small businesses.

Small businesses needed a fiscal intermediary to collectively represent small businesses and negotiate face to face with the local tax offices. The CNA assisted with regular bookkeeping, budgeting, management of the Value Added Tax, and the fiscal intermediation in the case of tax assessments. The CNA adopted a two-pronged approach to the issues of fiscal intermediation. On the one hand, it utilized its territorially pervasive organizational structure to offer its fiscal services to as many firms as possible. The wide diffusion of the service was aimed at reaching the ‘critical mass’ of firms needed to consolidate the bargaining power of the association vis-à-vis the provincial tax offices, and guarantee an effective fiscal intermediation.

This mechanism of fiscal intermediation enabled the CNA to implement a ‘soft’ strategy of formalization, because it represented an intermediate step between complete informality and full taxation on the basis of the actual income. Accordingly, the CNA could pressure its members to declare at least a level of income in line with the official estimates and at the same time negotiate more ‘affordable’ tables of presumed taxable income with the fiscal authorities.

The centralized provision of business development services by the association imposes a sort of control mechanism on MSSEs, which become more visible to the public authorities. In addition, this approach improves the economic performance of MSSEs by reducing the managerial, technological, and market information gap between large and small enterprises.

**Analysis**

METR calculations METRs for the tax on capital are given in Tables 21 and 22 for each bracket for small businesses operating in the manufacturing, tourism and agricultural sectors. These calculations are based upon the assumption of a small open economy with perfectly mobile capital internationally, and therefore do not incorporate domestic taxes on savings. However, it is useful to consider these calculations for comparative purposes with other sectors in the economy. Below we present alternative calculations under a closed economy assumption which reflects domestic taxes on savings. Panel A of Table 21 presumes that the small business is registered for the VAT, and therefore bears no taxes on its business inputs. Panel B presumes that the businesses are not VAT registered, and therefore bear some VAT on their capital purchases.

A unique feature of the small business regime in Tanzania is the ability of businesses to opt for a flat payment in each of the four tax brackets rather than a percentage of turnover. METRs are not presented for business operating under this option as these flat payments are independent of the amount of capital imposed and do not affect investment at the margin.

Looking first at Panel A, under which no VAT is borne by capital inputs, it is evident that for the lower tax brackets the METRs on small businesses are significantly below their large business counterparts in Table 7. However, as the small businesses move up the tax brackets, their METR approaches, and in some cases exceeds, the METR on large businesses. For example, in Panel A a small business in the highest presumptive tax bracket in manufacturing faces a METR of 15.8%, compared to 15.3% for a large firm. In agriculture, the small business METR exceeds the large business METR for firms in the third and fourth brackets.

The reason for this is that turnover taxes are a very blunt tax as they grant no deductions associated with capital expenditures. Even at relatively low rates they can impinge significantly on the return to capital. We saw this in the agricultural sector with the cess. Moreover, as discussed, the Tanzanian corporate income tax system as it applies to large businesses is quite generous, in particular because of the initial investment allowance. Small businesses under the presumptive turnover regime do not benefit from these write-offs.

Turning to Panel B in Table 21, it is evident that non-registration for VAT can have a significant impact on the METRs facing small businesses. The reason for this is that non-registered businesses cannot claim the input tax credit on the VAT levied on their capital purchases. With a relatively high VAT rate of 20% this can impose a substantial burden on the capital invested by small businesses. It is recognized that VAT compliance in Tanzania is quite low, and therefore that
small business may well purchase many of their inputs informally or from other non-registered businesses. The calculations in Table 21B thus presume that only half of capital inputs bear the VAT.

As discussed above, MSSEs differ from large corporations in their ability to access international financial markets. For large corporations, Tanzanian personal income taxes levied on the return to capital in the form of taxes on interest, dividends and capital gains have no impact on domestic investment because the required after-corporate-tax rate of return on investments is fixed by international financial markets. Small businesses, on the other hand, cannot access these markets. These businesses effectively face a segmented local capital market that can be thought of as closed for analytical purposes. This means that personal income taxes paid by Tanzanian investors in MSSEs may well have a sizable effect on domestic investment by lowering the after-all-taxes (corporate and personal) rate of return.

Table 22 provides METR calculations for MSSEs under these assumptions. Unlike Table 21, which incorporate only corporate taxes levied capital income, as discussed above these calculations incorporate both corporate and personal income taxes. The calculations show that the METR on capital rises substantially when the capital market is closed. This is because of the imposition of taxes on capital at the personal level. This suggests that if one considers the impact of the entire tax system – corporate and personal taxes – on small businesses in a closed capital market context, the METR on “entrepreneurial” investment undertaken by small businesses, is quite high.
Table 21A: Marginal Effective Tax Rates on Capital: Tanzania, Small Businesses, VAT Registered, Open Economy

<table>
<thead>
<tr>
<th></th>
<th>Manufacturing</th>
<th>Tourism</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Equipment</td>
<td>9.3%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Buildings</td>
<td>5.0%</td>
<td>5.7%</td>
</tr>
<tr>
<td>Land</td>
<td>1.4%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Inventories</td>
<td>1.4%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Total</td>
<td>6.7%</td>
<td>7.6%</td>
</tr>
</tbody>
</table>

Agriculture

<table>
<thead>
<tr>
<th></th>
<th>No cess</th>
<th>cess</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Equipment</td>
<td>11.6%</td>
<td>13.1%</td>
</tr>
<tr>
<td>Buildings</td>
<td>2.8%</td>
<td>3.1%</td>
</tr>
<tr>
<td>Land</td>
<td>1.4%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Inventories</td>
<td>1.4%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Total</td>
<td>4.0%</td>
<td>4.6%</td>
</tr>
</tbody>
</table>

Table 21B: Marginal Effective Tax Rates on Capital: Tanzania, Small Businesses, Not VAT Registered, Open Economy

<table>
<thead>
<tr>
<th></th>
<th>Manufacturing</th>
<th>Tourism</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Equipment</td>
<td>45.5%</td>
<td>46.0%</td>
</tr>
<tr>
<td>Buildings</td>
<td>5.0%</td>
<td>5.7%</td>
</tr>
<tr>
<td>Land</td>
<td>1.4%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Inventories</td>
<td>1.4%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Total</td>
<td>31.3%</td>
<td>31.8%</td>
</tr>
</tbody>
</table>

*Agriculture is not included as the sector is VAT exempt.*
### Table 22A: Marginal Effective Tax Rates on Capital: Tanzania, Small Businesses, VAT Registered, Closed Economy

<table>
<thead>
<tr>
<th></th>
<th>Manufacturing</th>
<th>Tourism</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td><strong>Equipment</strong></td>
<td>21.9%</td>
<td>22.7%</td>
</tr>
<tr>
<td><strong>Buildings</strong></td>
<td>19.3%</td>
<td>19.8%</td>
</tr>
<tr>
<td><strong>Land</strong></td>
<td>17.2%</td>
<td>17.4%</td>
</tr>
<tr>
<td><strong>Inventories</strong></td>
<td>17.2%</td>
<td>17.4%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>20.3%</td>
<td>20.9%</td>
</tr>
</tbody>
</table>

### Table 22B: Marginal Effective Tax Rates on Capital: Tanzania, Small Businesses, Not VAT Registered, Closed Economy

<table>
<thead>
<tr>
<th></th>
<th>Agriculture</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
</tr>
<tr>
<td><strong>Equipment</strong></td>
<td>23.3%</td>
</tr>
<tr>
<td><strong>Buildings</strong></td>
<td>18.0%</td>
</tr>
<tr>
<td><strong>Land</strong></td>
<td>17.2%</td>
</tr>
<tr>
<td><strong>Inventories</strong></td>
<td>17.2%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>18.7%</td>
</tr>
</tbody>
</table>

Agriculture is not included as the sector is VAT exempt.

**Recommendations**

- Presumptive regime.
  - Designate a zero rated band at the bottom end for small firms so as to harmonize with personal income tax.
  - Increase presumptive threshold from TSH 20 million to TSH 40 million to harmonize with VAT threshold. Allow opt-in to the standard corporate income tax regime for small businesses below the presumptive threshold, if they comply with record keeping and compliance obligations.
o Revise rates for non-record keepers to apply consistent progressivity in average effective tax rates.

- **Allow easy opt-in for VAT registration.**

Businesses should be able to opt into the VAT system without need for prior government approval for small businesses turnover below the registration threshold of TSH 40 million.

- **Shift to quarterly or bi-annual filing of returns for VAT for small taxpayers.**

This will reduce the administrative burden in small businesses. Care needs to be taken that small businesses do not ‘lose the habit of paying taxes’ by paying less frequently and that funds accumulated during the quarter to meet the payments are used for working capital etc.

- **Increase outreach function under planned SBTUs to encourage voluntary compliance.**

Focus greater attention by regional and district offices on small taxpayers.

**Zanzibar**

**Summary of the tax/incentive system**

The Government of Zanzibar has autonomy over some, but not all, tax instruments. The Zanzibar Revenue Board (ZRB), operates in parallel to the TRA and was established in 1996. The ZRB collects VAT, a Hotel Levy, Stamp Duty Levy and Port Services Charges on behalf of the Government of Zanzibar. There is also a restaurant levy, fuel duty and tour operators levy.

Customs remain a Union matter, as does income taxation (corporate and personal).

Over a third of Zanzibar’s revenue is administered by TRA. Of the revenue raised by ZRB over half comes from VAT. (There are 475 VAT registered traders). The ZRB has proven increasingly effective at raising revenue: from 950 TSH per month in 2,000 to 4.3 billion TSH in 2005. More recently however, it has missed its revenue targets (as show in Table 23).
Table 23: Zanzibar Revenue Performance

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mainland</td>
<td>1,280</td>
<td>1,339</td>
<td>1,602</td>
<td>1,625</td>
<td>949</td>
<td>945</td>
</tr>
<tr>
<td>Zanzibar</td>
<td>30</td>
<td>21</td>
<td>28</td>
<td>20</td>
<td>15</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: Tax Administration Project and Tax Modernization Program, Multi-development Partner Implementation Support Mission, December 2005, Final Aide Memoire

In 1992 the Zanzibar Free Economic Zones Authority was established, which operates an active program of Export Processing Zones. These provide:

- Corporate tax holiday (0%) for 10 years for enterprises (and subsequent five years tax at 25%) which export 80% or more of their output;
- Exemption from custom duties & other taxes on imports of plant and equipment, raw materials;
- No withholding & secondary taxes on dividends and/or net earnings of enterprises operating in EPZs;
- Exemption on withholding and income tax on dividend interest, loans on shareholders;
- Free repatriation of profits; and,
- 100% foreign ownership allowed.

The tax/incentive system in practice

From the perspective of the Zanzibar business community it is not ideal to have to engage with two separate revenue authorities. Tanzania is not alone with this issue - any governmental system which provides tax raising powers to different tiers of government is in a similar situation (including the USA for example). Effective co-ordination is key (similarly with local taxation on the Tanzanian mainland) to mitigating the impact of parallel taxation systems and administrations. There is now a Memorandum of Understanding in place between the ZRB and the TRA covering issues such as investigation and education.

The economy of Zanzibar has transformed from being agriculturally based to tourism based. Therefore it is the tourism industry that is most affected by the dual taxation system. There is anecdotal evidence of misunderstanding between the tourism enterprises and the ZRB and TRA, over what taxes, fees and levies are applicable in what circumstances.

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42 Bolnick (2004)
Some businesses – irrespective of turnover – pay VAT at 20% while others pay sales tax at 10% plus stamp duty (at 1.5%). Still other businesses in tourism are paying sales tax at 15% plus stamp duty (this is the “hotel levy” paid by some hotels).

Many businesses (especially small ones) supplying the tourism sector have elected to stay out of VAT, (there are only 475 VAT registered traders on the island). As a result, tourism businesses in the VAT system have very little input VAT to deduct at the end of the month.

Special Economic Zones

As noted above, the Government of Zanzibar has established Export Processing Zones. The Tanzanian mainland is also considering Special Economic Zones. The arguments for and against such vehicles to attract investment are well laid out in the Aide Memoire of the most recent Multi-development Partner Implementation Support Mission of the Tax Administration Project (2005).

Table 24 puts the arguments for and against special economic zones compared to other investment incentives. Many EPZs (including those in Zanzibar) combine tax incentives within an EPZ structure.

The METR model provides a gauge for evaluating the extent to which various tax incentive packages improve the rate of return for representative investment projects, at the margin. An ‘ideal’ tax incentive would provide for a substantial reduction in the METR for a proposed investment, while at the same time leading to a minimum of revenue loss to the fiscus. The advantages and disadvantages of each tax instrument must be judged in light of local conditions, subject to systematic policy analysis to support well informed decisions. Nevertheless, METR analysis suggests broad conclusions about the choice among tax incentive instruments.43

- Overall, the soundest tax incentive is to establish standard tax rates that are fair and moderate.
- Relieving exporters of indirect tax on inputs should be a top priority, with due regard to the need for effective procedures to prevent abuse of the remissions. (As is the case in Tanzania).
- The most cost-effective tax incentives are the Income Tax Credit and the Initial Capital Allowance. These tools yield a large reduction in the METR relative to the revenue cost, with a minimum of administrative complexity. Yet they also create moderate distortions favoring capital-intensity and

43 Bolnick *ibid.*
short-lived assets, and can serve as avenues for tax evasion if not well administered.

- **Tax holidays** entailing a full exemption are less likely to be cost-effective. The revenue loss tends to be large relative to the improvement in incentives. Tax holidays strongly favor transitory rather than sustainable investments, and create glaring opportunities for aggressive tax avoidance.

- **In states with serious revenue constraints**, selective tax breaks (if used at all) should narrowly focus on activities that are likely to deliver an especially high payoff in terms of policy goals, and which would not be undertaken without special incentives.

- **Avoid zero tax rates.** The vast majority of viable investment projects do not hinge on getting a total exemption from tax.

- **Eliminating import duties on raw materials and intermediate goods** is a poor way to stimulate investment. The measure has a high revenue cost and little effect on investment for the domestic market since indirect taxes are usually passed along to consumers. (However, mechanisms are needed to eliminate the burden of duties on inputs used to produce for export.)

- **Location-dependent investments** that are fundamentally viable, especially resource based projects that cannot readily move elsewhere, should not receive special tax preferences.

- **A low-rate alternative minimum tax** can ensure that every company contributes at least minimally to the cost of basic public services.

### Table 24: Relative Pros and Cons of Different Types of Tax Incentives

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
</table>
| **1. Lower CIT rate**                                                     | Largest benefits go to high-return firms that are likely to have invested even without incentive.  
Invites tax avoidance through high-tax enterprises shifting profits to low-tax ones via transfer pricing (intra-country and international).  
Unlike specific benefits, may not be tax spared by home country tax authorities.  
Acts as windfall to existing investments                                           |
| Simple to administer. Revenue costs are more transparent.                |                                                                                                                                               |
| Simple to administer. Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt). | Invites tax avoidance through the indefinite extension of holidays via creative re-designation of existing investment as new investment.  
Revenue costs are not transparent unless tax filing is required, in which case administrative benefits are foregone.  
Attracts short-run projects.  
Creates competitive distortions between old and new firms.  
Same as lower CIT rates, except might be tax spared.                                  |
## 3. Investment allowances and tax credits

<table>
<thead>
<tr>
<th>Revenue costs are more transparent. Can be targeted to certain types of investment with highest positive spillovers.</th>
<th>Distorts choice of capital assets in favor of short-lived ones, since a further allowance is available each time an asset is replaced. Qualified enterprises may attempt to abuse the system by selling and purchasing the same assets to claim multiple allowances. Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate. Greater administrative burden.</th>
</tr>
</thead>
</table>

## 4. Accelerated Depreciation

<table>
<thead>
<tr>
<th>All of the benefits of investment allowances and credits. Does not generally discriminate against long-lived assets. Moves the CIT closer to a consumption-based tax, reducing the distortion against investment typical of regular CIT.</th>
<th>Some administrative burden. Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate.</th>
</tr>
</thead>
</table>

## 5. Exemptions from Indirect Taxes (VAT, import tariffs, etc.)

<table>
<thead>
<tr>
<th>Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt).</th>
<th>Prone to abuse-easy to divert exempt purchases to unintended recipients. VAT exemptions may be of little benefit-under regular VAT, tax on inputs is already creditable; outputs may still get taxed at later stage.</th>
</tr>
</thead>
</table>

## 6. Export Processing Zones

<table>
<thead>
<tr>
<th>Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt).</th>
<th>Typically results in substantial leakage of untaxed goods into domestic market, eroding the tax base. Distorts location decisions.</th>
</tr>
</thead>
</table>


### Recommendations

- **Undertake a separate and rigorous assessment of the impact of the dual tax structure on the investment climate in Zanzibar, with a focus on the tourism sector.**

- **Provide up to date, accurate and accessible information to all business on their tax responsibilities and rights.**

Tax issues between national and sub-national governments are often an area of concern for businesses. This study was only able to begin to understand the depth and extent of the tax challenges faced by businesses in Zanzibar. Clearly before any reforms can be made, a further rigorous in depth study is required – which could potentially be funded through the multi donor TAP.
While long term reforms are considered, progress can be made in the short term by clarifying to the business community exactly what taxes are owed to which organization and when. Publication of this information, for example through newspapers, leaflets or the radio, would help in this regard.

**Tanzania in Comparison with Neighboring Countries**

For purposes of comparison, Tables 25-28 provide the METRs on capital income in the South Africa, Rwanda and Zambia. The METRs are calculated for the general tax system in each of these countries and reflect only provisions available either to all firms or to all firms within one of the sectors analyzed in the report; that is, the report does not consider incentives granted to specific firms within a sector or to other categories of firms such as exporters or firms in tax-favored regions. Since the treatment of mining is relatively idiosyncratic, the comparison examines the tax treatment in the other four sectors – manufacturing, tourism, agriculture and financial services. Annex D presents a schematic overview of the tax and incentive schemes in each comparator country, but the full reports provide all the necessary information.

**Table 25: Comparison of METR Calculations in Agriculture**

<table>
<thead>
<tr>
<th></th>
<th>Rwanda</th>
<th>South Africa</th>
<th>Tanzania (with cess)</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>29%</td>
<td>8%</td>
<td>30.3%</td>
<td>11.9%</td>
</tr>
<tr>
<td>Buildings</td>
<td>12%</td>
<td>5%</td>
<td>16.3%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Land</td>
<td>-13%</td>
<td>5.3%</td>
<td>8.7%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Inventories</td>
<td>-13%</td>
<td>5.3%</td>
<td>27.5%</td>
<td>24.1%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>7%</td>
<td>5.7%</td>
<td>23.1%</td>
<td>n/a</td>
</tr>
</tbody>
</table>

*Does not include land tax, which results in METRs well over 100%.*

**Table 26: Comparison of METR Calculations in Manufacturing**

<table>
<thead>
<tr>
<th></th>
<th>Rwanda</th>
<th>South Africa</th>
<th>Tanzania</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>22%</td>
<td>14%</td>
<td>3.8%</td>
<td>-11.1%</td>
</tr>
<tr>
<td>Buildings</td>
<td>22%</td>
<td>25.6%</td>
<td>27.7%</td>
<td>-1.3%</td>
</tr>
<tr>
<td>Land</td>
<td>-13%</td>
<td>5.3%</td>
<td>1.6%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Inventories</td>
<td>-13%</td>
<td>32.4%</td>
<td>21.9%</td>
<td>49.2%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>17%</td>
<td>21.3%</td>
<td>15.3%</td>
<td>n/a</td>
</tr>
</tbody>
</table>
Table 27: Comparison of METR Calculations in Tourism

<table>
<thead>
<tr>
<th></th>
<th>Rwanda</th>
<th>South Africa</th>
<th>Tanzania</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>23%</td>
<td>17.4%</td>
<td>-3.8%</td>
<td>-11.1%</td>
</tr>
<tr>
<td>Buildings</td>
<td>13%</td>
<td>13.5%</td>
<td>20.5%</td>
<td>-1.3%</td>
</tr>
<tr>
<td>Land</td>
<td>-13%</td>
<td>5.3%</td>
<td>1.6%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Inventories</td>
<td>-13%</td>
<td>32.4%</td>
<td>21.9%</td>
<td>49.2%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>13%</td>
<td>13.9%</td>
<td>14.9%</td>
<td>n/a</td>
</tr>
</tbody>
</table>

*Does not include land tax, which results in METRs well over 100%.

Table 28. Comparison of METR Calculations in the Financial Sector

<table>
<thead>
<tr>
<th></th>
<th>Rwanda</th>
<th>South Africa</th>
<th>Tanzania</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>46%</td>
<td>43.3%</td>
<td>42.5%</td>
<td>37.7%</td>
</tr>
<tr>
<td>Buildings</td>
<td>11%</td>
<td>17.1%</td>
<td>17.4%</td>
<td>-0.9%</td>
</tr>
<tr>
<td>Land</td>
<td>-13%</td>
<td>5.3%</td>
<td>1.3%</td>
<td>9.7%</td>
</tr>
<tr>
<td>Inventories</td>
<td>-13%</td>
<td>32.4%</td>
<td>21.7%</td>
<td>59.5%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>28%</td>
<td>29.8%</td>
<td>28.9%</td>
<td>n/a</td>
</tr>
</tbody>
</table>

*Does not include land tax, which results in METRs well over 100%.

These results suggest that METRs in Tanzania are compare with those in South Africa, Zambia and Rwanda. The exception is the METR in agriculture when the cess is included.

Thus, it seems that the tax component of the investment climate in Tanzania should not be a significant barrier to investment, relative to the tax systems of neighboring countries.

Finally, it is worth noting that METRs in developed (OCED) countries are not necessarily lower than developing countries. The average METR on manufacturing in Canada for example is 35.5%, in Australia 29.4%, New Zealand 30.1% and India 23.2%. All of these are higher than the METR in manufacturing in Tanzania (15.3%).

Commentators typically believe that developed countries can sustain higher effective tax rates on capital than less developed countries, simply because developed economies have other characteristics that are attractive to capital investment. Less developed economies, on the other hand, need to impose low taxes on capital in order to overcome the lack of these other factors and attract capital.
3. POLITICAL ECONOMY OF REVENUE COLLECTION IN TANZANIA

Background

This part of the project explores the political and institutional dimensions of tax policy and its administration with the aim of providing governments with an international, national and sector perspective. Findings may reflect both political issues and bureaucratic procedures. For example, RAs could be specifically targeting large national or foreign companies because of political influence, bureaucratic convenience, or simply because such an approach responds to RAs’ immediate incentives for maximizing revenue, but with potentially serious long-term implications for both economic growth and political stability. By analyzing the political economy of different types of business and the informal sector in relation to tax impacts, FIAS hopes that governments will be able to improve the tax impact on business to improve long-term development aims.

The project also aims to understand how the private sector (of all types: large/MSSEs/informal/foreign & domestic etc.) and its representative bodies engage in the taxation process, with what objectives, degree of coordination and potential influence over both process and sustainable outcomes.

The project therefore seeks to produce evidence as to whether business engagement with the tax process is improving business ‘voice’, for example in the way that taxes are spent, and thereby contributing to improved taxpayer compliance. For instance, do businesses, while seeking to minimize their taxes, also accept that paying taxes give them the right to demand effective supporting services and to achieve political representation?
Box 20: Taxation and Gender

Although this series of country studies is focused on the link between taxation and growth, the link between gender and taxation remains important, not least because women make up a significant proportion of small scale entrepreneurs. Explicit gender biases in tax law are rare and none exist in Tanzania. Implicit biases, where-by men and women are affected differently by application of a uniform tax system, are more common. Four examples:

i) *Personal income tax regimes* can be gender biased if they require joint-filing, taxing household income at a higher marginal rate and so deterring women from entering the paid workforce. There is no such requirement in Tanzania.

ii) A uniformly applied *consumption tax* would be gender neutral if all goods and services are taxed at the same rate and men and women had the same consumption patterns. In reality, women tend to consume certain goods and service more than men (e.g. healthcare, food, education), which are often zero rated or exempt from VAT or sales tax. In Tanzania, healthcare, food and education products are exempt from VAT and so women may bear a disproportionately small burden of indirect taxation.

iii) *Corporate taxes* affect legal entities and so the gender impact is only felt through the employees of the company (personal income tax), or the companies’ products (consumption taxes). To the extent that the owners of companies (who are affected by taxes on corporate profits) tend to be men, there may be some gender differentiation.

iv) *Trade taxes* can affect women disproportionately through three channels: as workers in sectors of the economy which are imported or exported; as consumers of imported goods; and as traders in exported goods.

In short, a gender neutral tax regime may still result in gender biases because of different working, spending and savings behavior. Adjusting tax systems to try and account for this would be a complex endeavor with the potential to create more problems than it solves. An optimal tax system remains one which is simple, fair and broadly applied with limited deductions or exceptions.


**Strengthening of the ‘Fiscal Contract’**

Governments and the international community have begun to understand that tax is a key political basis for state/society relations. Taxation, aid and democracy are closely related in poor aid-dependent African countries. The way domestic revenue is raised significantly influences both economic growth and democratic consolidation. Bargaining over tax is central to building relations of accountability based on mutual rights and obligations, rather than on patronage.
Taxpayers’ mobilization around common interests has potentially positive outcomes for governance.\textsuperscript{44}

Management and governance of the TRA

The TRA was established in 1995 and became operative in 1996. The TRA’s main functions are to administer, assess, collect and account for all revenues due under Tanzania's tax laws, and to advise the Government both on changes to those laws and fiscal policy in general.

In contrast to many other revenue authorities in the Region, board and executive management positions in the TRA have been filled with Tanzanians since its establishment. Persons recognized for their integrity and past performance have been appointed as Chairperson of the Board and Commissioner General. With few exceptions, the executive management have been recruited from outside the system, predominantly from jobs in state-owned enterprises.

The President appoints the Commissioner General of the TRA, who is also the chief executive. The TRA’s Board of Directors consists of ten members, including the Secretary to the Board. The Chair is appointed by the President on the recommendation of the Minister of Finance. There are five ex-officio members: Permanent Secretary of Finance, the Union Government; the Principal Secretary of Finance, the Zanzibar Government; the Principal Secretary of the Planning and Privatization Commission; the Governor of the Bank of Tanzania and the Commissioner General of TRA. In addition, the Minister of Finance appoints four other Board members on the basis of their relevant experience and qualifications. Since the TRA was established in 1996, several economists from academic institutions have been members of the Board, and also chairpersons.\textsuperscript{45} Moreover, currently two Members of Parliament are members of the TRA Board, including one from the Parliament’s standing Finance and Economic Affairs Committee, and one from the Public Accounts Committee. The tenure of office for the members is three years and non-ex-officio members can be re-appointed only once. The Board of Directors is required, according to the TRA Act, to meet at least once every month to review the main aspects of the operations and

\textsuperscript{44} As Professor Mick Moore has noted: “If one starts from the assumption that a core governance problem lies in the dearth of bargained exchange relationships between the state and any organized societal group, then any collective action on the part of business to negotiate with the state over taxation might be considered to be potentially positive, even if it takes place entirely outside any representative or legislative institutional framework.” M. Moore: Revenues, State Formation, and the Quality of Governance in Developing Countries: International Political Science Review (2004), Vol. 25, No. 3, p.312.

\textsuperscript{45} The current chairperson is Senior lecturer and Head of the Department of Finance, University of Dar es Salaam, and the first chair (1996-98) was Executive director of the African Economic Research Consortium.
performance of the revenue authority and to provide required advice and guidance about changes in direction and practical issues of implementation.

Funding of the TRA

Annual TRA operations are financed via the general government budget. The TRA prepares a budget based upon its annual action plan and on revenue targets that are negotiated with the Ministry of Finance (see Mann 2004:20). Since the revenue target constitutes an annually moving target, it does not provide a solid base from which TRA can carry out multi-year planning of its operations. In FY 2003/04, for instance, the budget allocated TSh 39 billion to the TRA, which constituted some 3% of the revenue collections (net of VAT refunds). This amount, however, merely covered current expenditures, and was insufficient to cover infrastructure, software, hardware, training needs etc (ibid). Most of the non-current expenditures are funded by external donor sources in the form of loans and grants, mainly under the donor supported Tax Administration Project (TAP). Recent TRA estimates have identified a financing gap of USD 16 million to complete planned reform initiatives in addition to the original TAP funding of USD 73 million (IMF 2005a:14).

Since, 1999 TAP has been coordinated by the World Bank, and has included support from several bilateral donors and the UNDP. From 2006 it has moved to a basket funding arrangement using government systems for procurement and reporting. The common basket approach has helped to facilitating donor coordination as well as being more responsive to TRA demands. World Bank funding is expected to conclude by 1 July 2006, while donor support is expected to continue through to 2008, which is the end of the current corporate planning period (2003/04 – 2007/08). This funding situation puts the autonomy of the TRA at risk. Since a continuation of the external donor support is not likely to be continued at current levels after 2008, it is essential to secure the TRA with reliable funding from domestic resources.

Recommendation

- **Consider installing a system where-by a portion of the TRA’s annual budget is given as an up-front percentage of gross revenue collection.** This will help secure the future autonomy of the TRA and stability for planning purposes.
The role of the TRA and Ministry of Finance in tax policy formulation

The key institutions involved in tax policy formulation are the Policy Analysis Department (PAD) in the Ministry of Finance (preparation of the budget with revenue policy measures), and TRA’s Research, Policy and Planning Department (RPPD). Some line ministries, including the Ministry of Energy and Minerals, also have a notable influence on tax policy formulation. Moreover, the IMF and the World Bank are involved in policy debates, in particular with respect to revenue targets (tax-to-GDP-ratio), policy proposals and technical details.

Revenue targets are set on the basis of negotiations between the TRA and the Ministry of Finance. Moreover, the RPPD of the TRA plays the unusual policy role of setting collection targets for the TRA revenue departments, once the total tax revenue budget has been agreed with the Ministry. This arrangement indicates a strengthening of the tax bureaucracy at the expense of politicians. It also amplifies the moral hazard problems when the tax collection agency becomes involved in the process where its own performance targets are set.

However, TRA’s roles as both a tax policy formulation and a tax policy implementation body must be seen in the light of the capacity constraints facing both the TRA and the MoF. By joining forces, the good working relations between the two institutions have facilitated the design and implementation of significant tax reforms during the last decade. The revenue administration possesses unique datasets on taxpayers and revenue bases, and this information is essential for improving tax policy and legislation.

Recommendation

- Over time, measures are required to secure an unambiguous demarcation of the policy formulating and the policy implementing roles of the MoF and the TRA, respectively. Such measures should not imply the end of mutual cooperation between the revenue administration and the Ministry of Finance.

During the last 1-2 years the PAD has been substantially strengthened through new recruitment. The strengthening of its analytical capacity, combined with the fact that the PAD deals with far more than tax policy, including public expenditure policies and fiscal transfers to local government authorities, it is likely that PAD soon will be in a better analytical position to formulate tax policies and to negotiate revenue targets.
Public-private consultations in tax policy formulations

Consultations between the private sector and government take place in both formal and informal fora, including the Taskforce for Tax Policy Reform; TRA’s Stakeholder Forum; the CEO Roundtable; and the Tanzania National Business Council. In addition, a range of business associations and individual businesses lobby the government on tax issues.

Among the institutionalized mechanisms, the ‘Taskforce for Tax Policy Reform’, composed of both the private and the public sector stakeholders, plays an important role. The Taskforce discusses and sets the broader guidelines for tax reform, drawing on inputs from the Policy Analysis Department’s macroeconomic and fiscal policy unit as well as the TRA’s Research and Policy Department.

Although the public sector dominates membership of the Taskforce, it provides an important forum for dialogue between the private and public sector on tax issues. The influence of the Taskforce on tax reforms has fluctuated over time, but seems to have increased recently, possibly reflecting the impact of long-term trust building between parts of the private sector and the government on fiscal issues.

In the run-up to the budget process, the Ministry of Finance publishes an annual request in the media for proposals to improve the workings of the TRA and the tax system. The major business associations canvass their members and produce position papers for the Taskforce, which sits for one month per year immediately prior to the budget. Business associations complain that because the Taskforce is open to anyone, too much time is devoted to individual contributions.

**Recommendation**

**Taskforce for Tax Policy Reform**

- Establish a mechanism to ‘filter’ proposal from individual firms, possibly by their member association. The taskforce should also be given more time for discussions in the budget process. The ‘Taskforce for Tax Policy Reform’ provides a unique and ‘homegrown’ forum for dialogue between the government and the private sector on tax policy. However, the effectiveness of the taskforce is eroded by the many individual interventions it has to address.

**Stakeholder Forum**

- TRA should consider revising the agenda for the Stakeholder Forum meetings so that they can better accommodate tax policy dialogue in addition to tax information. The Stakeholder Forum provides a
potentially important entry point to improve the dialogue and communication between the revenue administration and taxpayers. However, the Stakeholder Forum is perceived by taxpayers interviewed as a mechanism for the TRA to better inform tax policy changes. Accordingly, the potentially important role the forum could have for dialogue, and thereby to clarify misunderstandings between the administration and taxpayers, is not working.

Political accountability of the TRA

Accountability and political control of the TRA revolves around what authority is delegated to the revenue authority, the depth and detail of monitoring conducted by Parliament and the Ministry of Finance (MoF), and the methods of recourse for those affected by the TRA’s activities, i.e. the taxpayers. A number of arrangements are in place to ensure that the TRA does what it is designated to do. This includes:

- Monthly revenue reports detailed on revenue sources and regional offices, as well as changes over time.
- Annual reports and audited accounts.
- The CG reports to the Permanent Secretary of the Ministry of Finance, and also interacts with the PS frequently, including briefings and monthly statements of revenue performance.
- Main stakeholders are represented in the TRA Board of Directors.

None of these arrangements can, however, guarantee that the Ministry of Finance will not lose control of the TRA, but they contribute to increase the visibility of the TRA’s activities, its performance over time with respect to revenue collection, and also provide the potential for regulation and control to be exercised more effectively. Our impression is that when it comes to accountability and attention to issues like delegation, monitoring and control by the MoF, measures are in place which to a large extent give attention to these factors.

TRAPh should be acknowledged for the quality and prompt regularity of its revenue reports. In addition to the hard copies of the reports submitted to some of the main stakeholders, the reports should also be published on TRA’s website. This measure will contribute to enhance TRA’s accountability vis-à-vis the general public.

The presence of two parliamentarians in the TRA Board adds positive to the political accountability to the TRA. The MPs are appointed as Board members due to their personal qualifications, and not due to their position as members of
Parliament. But since the TRA Board is involved in tax policy making (see below), this implies that the Parliament is indirectly involved in tax policy making. However, the general parliamentary oversight of the TRA is weak. This observation is not unique to the TRA, but applies to budgetary and public finance issues in general. In a recent study, which examined the accountability relations between political and administrative power holders, two thirds of the MPs interviewed felt that the budget process was weak or less than satisfactory and that it needed to be strengthened (OPM et al, 2005). The extent of understanding of complex budgetary issues, including taxation, amongst MPs is relatively limited. This is worsened by the weak research support, limited resources and information. According to the MPs interviewed, there is also limited transparency over how and why decisions are made. Moreover, tax policy is given less attention by MPs who, in general, are more focused on the expenditure side of the budget: MPs are largely judged by voters according to their ability to ‘bring the goods home.’

For instance, the abolishment of the development levy (a local government poll tax) in July 2003 was taken by the Executive and a few senior ministers, without Parliamentary approval (OPM et al, 2005). Although the decision was very popular, MPs had no influence on the decision. This does not necessarily imply that the Executive and the Cabinet intend to hide information or to deceive Parliament, but it reflects how little attention is given to Parliament in the tax policy-making process.

**Recommendation**

- **Provide greater advisory, training and research support to improve the technical capacity and basic skills of MPs in public finance and tax policy**, including how to read and understand government budgets. Priority should be given to members of the Finance and Economic Affairs Committee and the Public Accounts Committee. Second, there is a need to increase the time available for scrutiny of the budget proposals. Third, more user-friendly information on tax reforms should be provided at an earlier stage of the budget cycle.

**Technical and Administration Issues**

Consultation and cooperation between the TRA and the Local Government Authorities (LGAs) are limited. Firms have to negotiate and provide similar information on their operations to several government bodies, imposing high compliance costs on the private sector. Moreover, the duplication of databases implies higher administrative costs on the public sector. For instance, the City Service Levy, which is the major local tax in urban councils, is levied as a fixed
percentage on the firm’s turnover\textsuperscript{46}, requires the same data for tax assessment that the TRA requires for income tax.

\textbf{Box 21: Closed List of Revenue Sources for Local Government (2005)}

<table>
<thead>
<tr>
<th>Taxes on property</th>
<th>Business and Professional Licenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property taxes</td>
<td>&gt; Commercial fishing license fee</td>
</tr>
<tr>
<td>Turnover taxes</td>
<td>&gt; Intoxicating liquor fee</td>
</tr>
<tr>
<td>City service levy</td>
<td>&gt; Private health facility license fee</td>
</tr>
<tr>
<td>Taxes on Goods and Services</td>
<td>&gt; Taxi license fee</td>
</tr>
<tr>
<td>&gt; Crop cess (maximum 5% of farm gate price)</td>
<td>&gt; Plying (transportation) permit fees</td>
</tr>
<tr>
<td>&gt; Forest produce cess</td>
<td>&gt; Other business license fees</td>
</tr>
<tr>
<td>Taxes on Specific Services</td>
<td>Market fees</td>
</tr>
<tr>
<td>&gt; Guest house levy</td>
<td>Other Taxes on the Use of Goods</td>
</tr>
<tr>
<td>Motor Vehicles, Other Equipment and Ferry Licenses</td>
<td>&gt; Forest produce license fees</td>
</tr>
<tr>
<td>&gt; Vehicle license fees</td>
<td>&gt; Building materials extraction license fee</td>
</tr>
<tr>
<td>&gt; Fishing vessel license fees</td>
<td>&gt; Hunting licenses fees</td>
</tr>
<tr>
<td></td>
<td>&gt; Muzzle loading guns license fees</td>
</tr>
<tr>
<td></td>
<td>&gt; Scaffolding/hoarding permit fees</td>
</tr>
</tbody>
</table>

\textit{Source: GSU Report}

In spite of recent rationalization of the local government revenue system, LGAs levy a large number of taxes, fees, licenses and charges. Lack of coordination between the central and local government levels leads to an increasing number of local taxes, which are difficult for taxpayers to understand. The TRA’s Taxpayer Information Centre receives a significant number of requests regarding local taxes and fees. According to a range of stakeholders interviewed, including government officials, local taxation is still a major constraint on the commercialization of smallholder agriculture and formalization of the small and micro enterprises. Specifically, multiple taxes (including fees and charges) make it difficult to enter new businesses and markets. Levies are perceived as exorbitant, often charged up-front irrespective of the size and type of business. Sometimes local and central taxes duplicate. The Team has also been informed by business people and senior civil servants that new taxes, fees and charges are introduced replacing nuisance taxes abolished by the government in recent years.

Coercive methods to enforce local taxes, fees and charges, legitimizes tax resistance and contributes to undermining the legitimacy of the tax system, encourage tax evasion and delays the formalization of the MSSE-sector.

\textsuperscript{46} 0.1% of turnover for the bank/financial sector, and 0.3% for the other sectors.
Recommendations:

- **There is an urgent need to build local government capacity in tax design and modern revenue administration.**

  This can be done in collaboration between the LGAs and Institute of Tax Administration’s, by offering a local government finance curriculum at the ITA.

- **A new LGA curriculum should be piloted by involving a limited number of LGAs.**

- **Further effort is required to harmonize local and central government taxes and fees, and to avoid duplication.**

- **There is a need for the TRA and the LGAs to share databases. In particular, this applies to data on firm’s income and turnover which is required for estimating the city service levy in urban councils.**

- **TRA’s Taxpayer Information Centre should be developed into a service centre for all taxpayers, which covers requests on all types of local and central government taxes, fees and licenses.**

### Taxpayer-tax administration relations

TRA’s current Corporate Plan 2003/04 – 2007/08 includes a set of objectives which address challenges facing the TRA with respect to taxpayers’ compliance, including measures to enhance the administration’s responsiveness, and to address integrity problems and accountability. As such, the TRA has incorporated a key element of modern tax administration, which emphasizes ‘customer service’ as a major measure to enhance compliance. Hence, in principle the TRA’s approach to address non-compliance has moved away from deterrence (stick) toward positive encouragement for compliance (carrot). This is also reflected in the Taxpayer’s Charter of 2005, which sets out the rights and obligations of the taxpayer, and the duties and service standards of the TRA in dealing with the taxpayer.

The TRA has made significant progress since its inception 1996 on both tax policy and tax administration. The private sector acknowledges this. However, problems in taxpayer and tax administration relations remain. In spite of tax laws which in general are well formulated and ‘business friendly’, TRA officers in practice have discretion over important decisions, such as those related to the determination of tax liabilities (assessments), selection of audits, litigation, etc. Many administrative procedures, including for reporting tax revenues, could be more transparent. Firms report that over-assessment of tax liabilities is common,
followed by ‘negotiations’ between the tax officer(s). This is compounded by a
general lack of specific sector expertise within the TRA.

Interviews with a large number of business people and business associations as
part of this study indicate that much of the new ‘customer friendliness’ is
perceived as merely ‘window-dressing’. With the exception of the larger
enterprises, taxpayers continue to experience discretionary assessments and
claims for bribes, rather than willing, responsive service. Accordingly, it seems
clear that customer service is most widely practiced to the relations between the
tax administration and its larger corporate clients in the Large Taxpayer
Department (LTD). 47

This observation highlights a wider problem, common in developing countries
such as Tanzania - the extent to which improvements in revenue performance
results from a high degree of focus by the TRA on larger, formal sector
corporations, at the potential expense of genuinely broadening the tax base. Thus,
the substantial increase in revenue collection in recent years, does not reflect the
development of a broad based fiscal contract between the state and society (see
Moore 2004), but the fact that the TRA is now targeting its efforts towards the
most revenue productive, though very few in number, taxpayers.

Recommendations

- The Taxpayer Charter should be developed into a legally binding
document.

At present, the document is a performance standard only, and not a legally
binding instrument. Both the taxpayer and the TRA must ultimately invoke the
relevant laws in acting on or seeking to prevent action which is inconsistent with
the Charter and the laws.

- Reform VAT and Income Tax Acts so that late repayments to and
from the private sector from taxpayers accrue equivalent interest
at the Bank of Tanzania rate plus five %.

This will have two effects. It will improve the standing of the TRA amongst the
private sector, as it will put the TRA on a level playing field (as is the case in
other revenue authorities in the region). Second, it will create an incentive for the
TRA to make timely payments of VAT or income tax to taxpayers.

47 By July 2005, the LTD administered 286 large taxpayers and secured almost 70% of domestic
tax collection.
Tax evasion and appeals

TRA has taken important measures in recent years to improve the enforcement of legal sanctions against tax fraud. Until 2003, all tax investigations – including ‘criminal’ ones (fraud and evasion) - were settled internally, which was seen as contributing to a lack of transparency of private deal-making. Since then, all fraud and tax evasion cases are referred to the Legal Services Department. Of the 259 investigations made in 2005, 36 cases were referred and of those, 32 went to the regional magistrates court (i.e. criminal investigations are handled via the regular criminal justice system). However, since the magistrates have handed out only fines and not prison sentences, the rewards of tax evasion outweigh the perceived risks. Hence, at present the judicial system may seem to be a major bottleneck for establishing a credible penalty system for fraud and tax evasion.

Box 22. Tax Amnesties: A way to increase compliance and broaden the tax base?

Revenue authorities occasionally use one time ‘tax amnesties’ as way of encouraging compliance and raising revenue. Tax amnesty programs have been employed in many US states, Belgium, France, Ireland and Italy. Amongst developing countries, they have been employed in Argentina, Bolivia, Chile, Colombia, Ecuador, Panama, Peru, Mexico and the Philippines.

<table>
<thead>
<tr>
<th>Advantages of Amnesties</th>
<th>Disadvantages of Amnesties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allow errant tax-payers to regularize their tax affairs without fear of punitive fines or criminal conviction.</td>
<td>Honest taxpayers get upset that tax evaders are given a ‘soft option’ and may pay less tax than taxpayers who abide by the law.</td>
</tr>
<tr>
<td>Allow tax agencies to collect outstanding taxes which can provide a one-off windfall of revenue; reduces the burden of the revenue authority on detecting fraud.</td>
<td>Can undermine guilt arising from tax evasion. (Unless accompanied by stricter penalties for tax evasion post amnesty).</td>
</tr>
<tr>
<td>Taxpayers may use an amnesty as an opportunity to turn over a new leaf, and so revenue increases in the long run.</td>
<td>Taxpayers begin to expect future tax amnesties, which can result in reduced compliance.</td>
</tr>
<tr>
<td>Allow for a transition period prior to a strengthened enforcement regime.</td>
<td>May not be economically viable; i.e. more revenue could be collected simply be stricter enforcement of existing law.</td>
</tr>
</tbody>
</table>

In the 2006 South Africa announced a tax amnesty for small businesses that have not been compliant. One of the aims is to afford those who have been historically marginalized an opportunity to regularize their tax status. Taxes and penalties will be waived for years of assessment ending on or before 31 March 2004, subject to a non-disclosure penalty of 10 per cent based on taxable income for 2005. Undoubtedly part of the drive behind South Africa’s small business amnesty scheme, was the success of the ‘foreign exchange control and tax amnesty scheme’ run from February 2003 to February 2004. The regularization of the foreign asset holdings and tax obligations raised the declared income tax base by some R1.4 billion.
Empirical studies show that the overall revenue effects of amnesty programs have been small relative to aggregate income tax revenues, with estimated effects frequently turning out to be statistically insignificant. Studies of the amnesties offered by US states show that they are not a particularly effective way to identify tax evaders and turn them into tax compliers. Tax amnesties at the national level (in France 1982, Ireland, 1998 and 1993, and New Zealand 1988) provide a more positive picture of impact on both revenue and taxpayer compliance. In 1998 Zambia introduced a tax amnesty which provided amnesty from prosecution, fines and other penalties, but not for unpaid tax or interest.

Overall, amnesties may have certain short-term benefits but a number of potential long-term costs in terms of revenue, compliance and respect for the tax system in general. The resultant balance after these inherent trade-offs have been taken into account should be the major influence on the decision whether or not to offer a tax amnesty. If a decision is taken to offer a tax amnesty, a number of design issues need to be taken into account. These include issues relating to coverage, length, any media campaign, personnel etc. After the amnesty, assessments of the success of the amnesty in terms of revenue, voluntary compliance levels and public attitudes towards taxpaying should be made.


Recommendation

- The Research, Policy and Planning Department (RPPD) of the TRA needs to conduct a detailed study into the enforcement regime.

The legitimacy of the tax system is dependent on a credible system for enforcement. At present, no systematic studies have been conducted to examine how the current system works, including its main bottlenecks (whether these are located within the TRA and/or in the judicial system.)

Tax exemptions

Tanzania offers a high number of duty and VAT exemptions via the TIC and other programs. Figure 4 illustrates duty and VAT exemptions as a percentage of gross collections from 2000 to 2005. While the proportion of duty exemptions has been falling steadily, from close to 30% in 2000 to 20% recently, the proportion of VAT exemptions has been growing, from 20% in 2000 to 25% in 2005; in 2004 the proportion exceeded 50%.

A proliferation of VAT exemptions exacerbates the problems with an already narrow base due to non-compliance. A high occurrence of tax exemptions reduces the tax base, increases the appearance of loopholes for tax evasion, and generates demand for yet more exemptions and loopholes. The composition of exemptions granted for customs duties in Tanzania in 2005 is illustrated in Figure 5 - showing that slightly above 50% of the exemptions were granted to TIC holders, 26% were granted to other private sector actors (individuals and firms), and 17% to donor funded projects.
Figure 4. Duty and VAT Exemptions as a Percentage of Gross Collections

![Duty and VAT Exemptions as a Percentage of Gross Collections](image)

Source: Tanzania Revenue Reports, provided by TRA.

Figure 5: Shares of beneficiaries of customs exemptions in Tanzania (2005)

![Shares of beneficiaries of customs exemptions in Tanzania (2005)](image)

Recommendations

- **Further limit tax exemptions, including those granted to aid organizations and their employees.**

This would help boost the credibility of both the revenue administration and the donors in relation to good tax practice, and at the same time, contribute to widening the revenue base and simplifying the tax system. The discontinuation of
customs duty exemptions for public sector imports of goods and services in 2002 (down from 18% 1998/99 to 2% in 2005), reflects the government’s commitment to address the problem. While procedures to tax donors and donor funded projects may not directly add any revenue to the budget, (as tax paid by donors may be deducted from total donor flows), it introduces a system of controls that may reduce fraud, and thereby contribute to raise government revenues. It may further improve both budgetary transparency and resource allocation by fully accounting for public investment costs. Moreover, it may contribute to a more fair competition between local and foreign companies competing for donor contracts.
Annex A: An Overview of the METR Methodology

A General Discussion

The impact of business taxes on investment is one of the most important areas in the study of taxation. The issue is complicated by the fact that corporate/business tax regimes are very complicated, and differ substantially across jurisdictions and types of capital. One cannot just compare statutory tax rates, but rather must incorporate tax depreciation (write-off) rates; special investment credits and allowances; other taxes on business capital – property taxes, capital taxes, turnover taxes, capital transfer taxes, etc.; tax holidays, etc.

Economists summarize the key elements of the business tax system with respect to investment in a measure called the Marginal Effective Tax Rate (METR) on capital. The METR is a summary measure of the effective rate of tax imposed on the rate of return generated by the last, or marginal, unit of capital a firm invests in. The METR is therefore a summary measure of the total distortion in the rate of return to capital imposed by the business tax system.

The purpose of this appendix is to explain the idea behind the calculation of METRs. We begin with a conceptual explanation of the concept, and then move into a slightly more formal discussion.

Conceptual Explanation of the METR

There are two main "stakeholders" that hold an interest in firms: debt holders and equity holders (owners or "shareholders"). In order to satisfy these stakeholders, an investment must earn a rate of return after the payment of all business taxes which is greater than or equal to the (weighted average) "hurdle" rate of return required by these stakeholders. The hurdle rate is the minimum rate of return acceptable to the stakeholders.

For example, say the (weighted average) hurdle rate of return is 10%. This means that all capital projects that earn a rate of return greater than 10%, after the payment of all business taxes, will be undertaken. So, it a firm invests in all projects with a rate of return greater than the hurdle rate, and it invests in projects with the highest rate of return first and then moves down the “menu” of capital projects available to it, the last (marginal) project undertaken will earn an after-tax rate of return of 10% exactly.

The derivation of the METR formula can be quite complicated, but the idea can be conveyed in a simple example. As above, say the hurdle rate of return is 10% - i.e., the minimum (weighted average) rate of return required by the stakeholders...
in the project after the payment of all business taxes is 10%. Say the business tax system is such that in order to earn a rate of return of 10% after business taxes, an investment must earn a rate of return of 15% before business taxes. The METR is then 33.33% (determined as (.15-.10)/.15). The METR therefore measures the share of the investment’s pre-tax required rate of return needed to cover the tax costs associated with the investment.

Note that the 33 1/3% METR could differ substantially from the statutory CIT rate because of the existence of other taxes, deductions, credits, allowances, etc. The METR will equal the statutory tax rate in the case of no debt financing, no investment incentives, no turnover or other implicit or explicit capital taxes, and if the tax depreciation rate is equal to the economic rate of depreciation.48 In general, the METR is higher (the tax distortion greater),

- the higher is the statutory CIT rate and other tax rates on capital - capital taxes, business taxes, property taxes, turnover taxes;

- the lower is the tax depreciation rate on capital relative to the "economic" depreciation rate;

- the lower are various tax incentives - investment tax credits, investment allowances, etc,

- the lower the proportion of investment financed by tax deductible debt

Several things should be kept in mind when interpreting the METRs calculated for this study. First, the METR should not be confused with the average effective tax rate (AETR)49. The AETR measures total taxes as a share of total income while the METR measures taxes paid by a marginal investment as a share of the required before-tax rate of return on that investment. The METR is thus a forward looking measure which measures the impact of taxes on the incentive to invest at the margin. The AETR is a backward looking measure which reflects previous investment decisions and taxes levied on the income generated by those past investments. METRs and AETRs can differ significantly. In particular, it is quite possible for the AETR to be quite high and the METR quite low, a vise-versa. Both measures are useful for tax policy analysis, but serve quite different purposes. The METR provides a measure of the incentive effects of the tax

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48 This also presumes no personal taxes or, equivalently, a small open economy with internationally mobile capital. See below.

49 To make matters even more confusing, average effective tax rates are often referred to as implicit tax rates.
system on investment. The AETR provides a measure of the burden of the business tax system and is a useful indicator of the distribution of the business tax burden across companies or sectors.

Second, it is important to understand that the METR measures the impact of taxation on the incentive to invest in capital inputs. Taxes that corporations pay on other inputs that do not impinge on the rate of return to capital, in particular various taxes imposed on labor, such payroll taxes, are not reflected in the METR on capital.

Third, it is important to emphasize that METR analysis is only one of several tools that should be employed in the analysis of the tax system. The calculations are based upon a hypothetical marginal capital investment subject to a rough caricature of the tax system. While several important aspects of the tax system can be incorporated into the calculations – such as the corporate income tax rate, tax depreciation allowances, investment allowances, tax credits, property and capital taxes, tax holidays, implicit sales taxes on inputs, the treatment of inventories, etc. – several simplifying assumptions must be made, and important nuances of the tax code cannot be captured in METR calculations. The methodology thus captures only the “big picture” aspects of the tax code and should be interpreted in this light.

Finally, it is important to note that the METR calculations reflect the statutory provisions of the tax system. As a rule, METR calculations do not reflect various administrative and compliance issues that are extremely important in determining how a tax system works “on the ground.”

Taxes on capital can lead to several types of distortions in an economy. First, a high overall METR on capital is indicative of a tax system that discourages investment, generating what might be called an inter-temporal distortion. Second, differences in METRs across assets suggest a tax system that distorts the allocation of investment across different types of capital – inter-asset distortions. Third, differences in METRs across sectors is indicative of a tax system that and across jurisdictions introduces distortions in the allocation of investment across industries, leading to inter-sectoral distortions.

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50 An example is loss carryforward provisions. While it is possible to incorporate loss carryforwards, this requires detailed information on the anticipated future profile of income and taxes, which is typically not available in reliable form.

51 An attempt to illustrate the importance of these issues in the METR framework is undertaken below.
All of these types of distortions – inter-temporal, inter-asset and inter-sectoral – can lead to an inefficient allocation of resources in the economy, and therefore to an economy that does not produce to its capacity, does not generate jobs to its capacity, and therefore does not grow to its capacity.

**More Formal Explanation of the METR**

Neoclassical investment theory tells us that a firm will invest in capital up to the point where, at the margin, the present value of the after-tax cash flow from the last dollar invested equals one dollar. Therefore the marginal unit of capital just breaks even in the sense that the present value of the cash flows after the payment of taxes just equals the one dollar cost. Thus, for a simple corporate tax system:

$$1 = \int C(1-u)e^{-\left(r_f - \pi - \delta\right)t} \, dt - t + uZ(1+t)$$

where $C$ is the asset’s pre-tax rental rate, $u$ is the corporate income tax rate, $r_f$ is the firm’s after-tax nominal discount rate (defined in more detail below), $\pi$ is the inflation rate, $\delta$ is the economic depreciation rate, $Z$ is the present value of the tax depreciation deductions on $1$ of capital (explained in more detail below), and $t$ is the implicit tax rate on $1$ of capital (for example a sales tax imposed on capital, an asset transfer tax, a turnover tax, etc.). The left hand side of the equation is the cost of $1$ in capital while the right hand side is the present value of the after-tax returns to that marginal unit of capital. The first term on the right hand side is the present value of the after-tax cash flows (net of depreciation) generated by the marginal unit of capital; the second term is the sales taxes paid on that unit of capital; the third term is the value of the tax depreciation allowances.

The term $Z$, which is the present value of the tax depreciation deductions on a $1$ capital expenditure, depends upon the form of the tax depreciation allowances (i.e., straightline or declining balance), whether or not tax depreciation allowances are indexed for inflation, and can incorporate tax incentives such as tax allowances and investment tax credits. For example, under a declining balance approach to tax depreciation with no allowance for inflation, $Z$ is equal to:

$$Z = \frac{\alpha}{r_f + \alpha}$$

where $\alpha$ is the tax depreciation rate (i.e., 20%, in which case $\alpha=0.2$). If inflation indexing of tax depreciation allowances is allowed the nominal discount rate $r_f$ is replaced with the real discount rate $r_f - \pi$. 
Under straight-line depreciation, where an asset is written off over $T$ years, and again assuming no inflation adjustment,

$$Z = \sum_{t=1}^{T} \frac{1}{T} \frac{(1/T)/(1+rf)}{t}$$

An investment allowance granted at rate $\theta$, for example in the presence of a declining balance approach, can be incorporated as follows:

$$Z = \theta + (1-f\theta)\alpha/(r_f+\alpha)$$

Where $f=1$ if the investment allowance reduces the subsequent depreciation allowances and $f=0$ if it does not. An investment tax credit granted at rate $\phi$ can be incorporated by replacing $\theta$ with $\phi/(1-u)$.

Integrating equation (1) to determine $C$, and subtracting the economic depreciation rate $\delta$, gives the before-tax, after depreciation, rate of return required to cover the firm’s opportunity cost of funds and the taxes associated with a marginal investment, commonly referred to as the user cost of capital:

$$r_g \equiv C - \delta = (1+t)(r_f-\pi+\delta)(1-uZ)/(1-u) - \delta$$

This is akin to the before-tax hurdle rate of return discussed above.

The user cost of capital as written above clearly reflects the corporate income tax and any sales taxes imposed on capital, which are levied on the demand side of the capital market. Personal taxes levied on the supply side of the capital market can enter the user cost of capital expression through the firm’s discount rate $r_f$.

The precise expression for $r_f$ (and the impact of personal taxes on the user cost of capital) depends upon several assumptions concerning the marginal source of funds to the firm and the extent to which capital is internationally mobile. The extent to which capital is mobile internationally, and therefore whether the domestic capital market should be thought of as closed or open, or some combination of the two, is a complicated question. It turns out that the assumption that one makes in this regard has a big impact on the expression for $r_f$ and important implications for the effect of the domestic tax system on investment.

To deal with this issue, we present several sets of calculations. First, we assume that large corporations operate in a small open economy with internationally mobile capital. This is a common assumption that is made in many METR studies. For small corporations, we take a slightly different approach. First, in order to compare the calculations directly with those of large corporations, we present a set of METRs under the small open capital market assumption. Second, we present another set of METRs for small businesses under the closed capital market assumption.
market assumption. The idea here is that small businesses do not have access to international financial markets, and may therefore be thought of as operating in a segmented, closed market for capital. One might think of the METRs for the closed economy case as the METRs on “entrepreneurial” firms.

As will be shown below, an important difference between the open and closed capital markets scenarios is that in the open economy case domestic personal taxes levied on the return to saving have no impact on the level of domestic investment. In the closed economy case, on the other hand, domestic taxes levied on the return to savings at the personal level can affect domestic investment undertaken by small firms.

In order to understand the distinction more easily, it is useful to start with the closed economy model and utilize a simple diagram. Figure 6 depicts the market for a homogeneous investment good in a closed economy. The investment demand schedule, \( I(r_g) \), gives the level of investment as a function of the before-all-taxes (gross-of tax) rate of return. The savings supply schedule, \( S(r_n) \) gives the level of savings as a function of the required after-all-taxes (net-of-tax) rate of return. All taxes mean both corporate and personal taxes. In terms of the conceptual framework laid out above, \( r_g \) is the before-all-taxes hurdle rate of return and \( r_n \) is the after-all-taxes hurdle rate of return.

Of course in a closed economy the level of saving must equal the level of investment. This means that there is an equivalence between taxes imposed on savings (the supply side) and taxes imposed on investment (the demand side); taxes imposed on both sides of the market impact upon both investment and savings. In equilibrium, given the taxes imposed on both sides of the market, the level of investment and savings in the diagram is \( I_e = S_e \), the gross-of-tax rate of return is \( r_g \) and the net-of-all-taxes rate of return is \( r_n \).

In the closed economy case the nominal cost of debt to the firms is the return to debt required to yield \( r_n \) after personal taxes, given by:

\[
(3) \quad r_d = \frac{r_n + \pi}{1 - T_i}
\]

where \( T_i \) is the domestic PIT rate on interest.

Similarly, the nominal cost of equity is given by:

\[
(4) \quad r_e = \frac{r_n + \pi}{1 - T_e}
\]
where $T_e$ is the domestic PIT rate on equity, which is a weighted average of the tax rate on dividends and the \textit{accrual equivalent} tax rate on capital gains.\footnote{More precisely, the tax rate on equity is $T_e=\gamma T_d+(1-\gamma)T_c$, where $T_d$ is the tax rate on dividends and $T_c$ is the accrual equivalent tax rate on capital gains. The accrual equivalent tax rate on capital gains reflects the fact that capital gains are taxed on realization and not on accrual. $T_e$ thus takes the deferral of capital gains taxes until realization into account. If one presumes a ten year holding period for shares, this typically means that the accrual equivalent tax rate on capital gains is approximately half of the realized, statutory rate.}

The discount rate facing the firm, $r_f$, is then a weighted average of the cost of debt and equity, given by:

\begin{equation}
    r_f = \beta r_d (1-u) + (1-\beta) r_e
\end{equation}

where $\beta$ is the debt/asset ratio. This reflects the fact that debt interests costs are deductible for CIT purposes, while the cost of equity is not.

The marginal effective tax rate on capital is the share of the before-tax-rate of return ($r_g$) required to pay the taxes on the investment ($r_g-r_n$):

\begin{equation}
    \text{METR} = \frac{r_g - r_n}{r_g}
\end{equation}

The METR therefore determines the share of the investment’s pre-tax required rate of return needed to cover the tax cost.

In the closed economy model it is important to note that there is an equivalence between supply side taxes on savings and demand side taxes on investment – both lead to a decrease in investment (and savings). If capital is perfectly mobile internationally and the domestic capital market is small in the sense that savings and investment decisions in the country have no impact on the “world” interest rate, the link between domestic savings and domestic investment is broken. This means that the equivalence between taxes levied on investment and taxes levied on savings no longer holds. An important implication of this is that domestic personal taxes imposed on savings may then have very little impact on domestic investment, though these taxes can still affect domestic savings.

This is most easily seen with reference to Figure 7. In an open economy the after-corporate-tax but before-personal-tax rate of return is fixed by world financial markets. Denote this fixed rate of return in real terms by $r_i$. Demand side domestic taxes imposed on corporate capital increase the before-corporate-tax rate of return required to generate this after-corporate-tax rate of return to $r_g$. Domestic investment in this case is $I_e$ and the METR on capital in an open economy is given by the tax wedge ($r_g-r_i$) divided by the gross-of-tax rate of return $r_g$. Supply side
taxes imposed on domestic savings decrease the after-personal-tax rate of return to \( r_n \), yielding domestic savings of \( S_e \). In the case depicted, the excess of domestic investment over domestic savings \( (I_e - S_e) \) is provided by foreign investment inflows. Importantly, while taxes on domestic savings affect savings and the share of domestic investment financed by foreigners, they have no impact on domestic investment itself (unlike in the closed economy model).

In terms of the user cost of capital framework laid out above, the internationally determined cost of funds determines the firm’s discount rate, \( r_f \) in the user cost of capital expression given in equation (2). An important consideration here is the identity of the marginal international investor. We assume that the marginal investor is an “average” of investors from G7 countries. If \( r_d \) is the nominal cost of debt facing the firm, fixed by international markets, then the nominal cost of equity is given by the arbitrage condition that the after-tax return to debt equals the after-tax return to equity, \( r_d(1-T_d^*) = r_e(1-T_e^*) \) where \( T_d^* \) is the tax rate on debt for the marginal international investor and \( T_e^* \) is the tax rate on equity. Then, in equilibrium the nominal cost of equity facing the firm fixed by international financial markets is:

\[
7 \quad r_e = r_d(1-T_d^*)/(1-T_e^*)
\]

and the weighted average nominal discount rate facing the firm is:

\[
8 \quad r_f = \beta r_d(1-u) + (1-\beta)r_e
\]

The after-corporate-tax, before-personal-tax, real rate of return fixed by international financial markets is then:

\[
9 \quad r_i = \beta r_d + (1-\beta)r_e - \pi
\]

and the marginal effective tax rate on capital in a small open economy is then:

\[
10 \quad \text{METR} = (r_g - r_i)/r_g
\]

All of the above formulas were developed for physical capital, in particular for depreciable capital like equipment and buildings. Non-depreciable capital, such as land, is easily accommodated by setting economic depreciation (\( \delta \)) and the present value of tax depreciation allowances (\( Z \)) equal to zero in the expression for the user cost of capital, \( r_g \) (equation (2)), giving:

\[
11 \quad r_g = (1+t)(r_f-\pi)/(1-u)
\]
For inventory capital the expression for the cost of capital can be shown to be:

\[ r_g = (1+t)(r_f - \pi + u\pi f)/(1-u) \]

where the parameter \( f \) is equal to 0 if LIFO inventory valuation is used for tax purposes and equal to 1 if FIFO is used. Thus, the use of FIFO inventory accounting is seen to increase the cost of holding inventory capital by virtue of the taxation of the inflationary increase in the cost of inventories.
Figure 6: Closed Capital Market
B Issues Illuminated by METR Analysis

The primary applications of METR analysis are twofold. First, the results of an METR analysis show the net effect of all components of the tax system on the level of the taxation of capital income generated by the marginal investment analyzed. Thus, a METR provides a measure of the actual tax burden on a prospective investment attributable to the existing (or proposed) tax system. Moreover, an appropriately weighted average of the METRs on specific types of investments can be constructed to provide a measure of the overall level of taxation of capital income in the economy, showing how the tax system distorts investment decisions (and, if individual level taxes are considered, saving decisions as well) and thus introduces inefficiencies or “excess burdens” into the economy.53

53“Distortions” of investment decisions must be measured relative a benchmark. In general, a tax system would not distort investment decisions only if the METR were zero on all types of investment; this would occur, for example, under an ideal consumption-based tax (Zodrow and McLure, 1991). In this case, METR differentials – and the associated distortions of investment decisions – would be measured relative to a benchmark tax rate of zero. However, under an income-based tax, the benchmark level of taxation of capital income is typically the statutory income tax rate. In this case, the distortion of saving/investment decisions implied by the taxation of capital income at the statutory rate is in a sense taken as given, and the distortions attributable to tax differentials are measured relative to the statutory income tax rate. In
Second, by considering a wide variety of investments that differ by asset, method of finance, investor or economic circumstances, METR analysis provides an indicator of the tax differentials that arise across different types of investments, that is, it shows how taxes affect the *composition* of investment. In particular, a METR analysis shows how the tax system results in a variety of distortions of investment decisions, thus creating additional efficiency losses, beyond those associated with simply taxing capital income at a uniform effective tax rate. The most commonly cited distortion is across types of assets, as differential taxation of different types of assets induces businesses to invest too heavily in tax-advantaged assets and too little in tax-disadvantaged assets. This of course translates into distortions across business sectors, as the tax system favors sectors with production processes that use tax-favored assets intensively and penalizes businesses that use relatively heavily taxed assets intensively. The following subsections discuss these distortions and a wide variety of others, all of which can be analyzed with an appropriately designed METR analysis.

**Distortions of the Level of Investment and Saving**

METRs provide an indication of the overall level of taxation of various forms of capital income and thus indicate how the tax system affects investment and saving decisions. Because they consider many aspects of the tax system, METR analyses often give very different results regarding the effects of the tax system on investment decisions than would a simple examination of statutory tax rates (or special preferences) in isolation. Effective tax rates that are far above or below the statutory rate indicate potential areas for reform, as relatively high positive rates act as a deterrent to investment, while negative METRs suggest that the tax system stimulates investments that are socially undesirable because they earn a return lower than the opportunity cost of funds.

**Distortions of the Allocation of Investment**

METRs are also very useful in identifying the extent to which the tax system distorts investment allocation decisions by asset and by business sector (given the benchmark level of taxation of capital income in the tax system). Apart from the addition, note that this discussion assumes that efficiency requires a tax system that is neutral across assets. This need not be true. For example, tax differentials may be desirable to correct for negative production externalities (e.g., pollution) or to offset other inefficiencies in the economy (e.g., inefficiencies in the taxation of labor income). These complications are ignored in the analysis, as they are best addressed with specific tax policies as needed (e.g., taxes on effluents or reform of the system of labor income taxation) rather than through the ordinary income tax system applied to capital income; for further discussion, see Gugl and Zodrow (2004).
arguments for differential taxation noted above, most public finance economists would argue that competitive markets are generally efficient in allocating resources. The implication of this view is that tax differentials are generally undesirable because the associated distortions of investment allocation decisions result in reduced productivity of investment; that is, a disproportionate amount of capital is allocated to those sectors and assets in which tax treatment is relatively favorable rather than to those sectors and assets where investment would be most productive in the sense of generating output valued by consumers. In other words, the tax system should generally be characterized by "economic neutrality" with respect to investment allocation decisions, or METRs that do not vary according to the type of asset or business sector.

In addition, METR analysis demonstrates the extent to which certain types of preferential treatment confer an advantage to the tax-favored activity. Indeed, METR analysis can be used to determine whether the effects of "preferential" treatment of certain forms of investment are in fact consistent with the intent underlying such treatment. For example, in some cases such as certain types of tax holidays, supposedly preferential treatment results in METRs that are actually higher than those under the ordinary income tax system. Similarly, a preferentially low tax rate in a sector can have the effect of increasing METRs if depreciation deductions and other investment allowances under the regular tax system are sufficiently generous.

**Method of Finance**

MTR analysis is useful in determining whether the tax system favors one form of finance over another. Under a market-based approach to tax reform, such distortions are also undesirable as they imply a tax-induced alteration of the allocation of risk-bearing in the economy. For example, a tax bias toward debt finance may increase the overall indebtedness of firms and thus increase the likelihood that costly bankruptcies – or perhaps even more costly government bailouts – will be incurred during an economic downturn.

In addition, tax differentials across methods of finance may discriminate against certain types of firms. For example, a tax system that results in an unusually high METR on new share issues will discourage investments by firms that tend to use new issue finance to a disproportionate extent, including new enterprises that have little retained earnings and limited access to debt finance. Again, most public finance economists would argue that neutrality with respect to firm financing decisions is a desirable property of tax system.
Choice of Organizational Form

METR analysis identifies the extent to which the tax system distorts decisions regarding the choice of organizational form. Typically, firms may be organized as corporations subject to the corporate income tax or non-corporate entities that are taxed on a “pass through” basis, with business income attributed to the individual owners and taxed under the personal income tax. Economic neutrality with respect to decisions regarding organizational form is also generally desirable, so that firms may select the form of business organization that best meets their needs without worrying about differential tax consequences.54

C Effects of Inflation

An important benefit of METR calculations is that they can be used to demonstrate how tax rate differentials, as well as the level of capital income taxation, vary with the rate of inflation. Unless a tax system is completely indexed for inflation, the pattern of METRs will be different for each expected steady state rate of inflation. The fluctuations of METRs with inflation can be considerable, especially for large differences in the expected inflation rate. Note that such variation in METR levels and differentials with inflation adds an element of complexity to investment decisions, as it makes it more difficult to interpret the effects of the tax system on alternative investments. Such uncertainty is likely to reduce the overall level of investment at any given inflation rate.

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54 As in the case of resource allocation, there may be externalities associated with the choice of organizational form; for example, tax enforcement may be less costly for firms that are publicly held corporations.
Annex B: Cross-country analysis

The data for this analysis is taken entirely from FIAS/DFID country studies prepared as part of this series of studies. METRs calculated below should be used for rough comparison purposes only. There are so many variables involved in a complete METR (e.g. whether cess is included in the agricultural sector in Tanzania or not), that a direct evaluation based on ‘raw’ METR numbers would be inappropriate.

As in the base case for Tanzania, the calculated METRs reflect business level taxes only and do not consider any withholding taxes on interest or dividends. In addition, all of the countries considered have broadly similar indirect taxes, with creditable VATs with rates that range from 14-20 % (recall that the standard rate for the VAT in Tanzania is 17.5 %) and have customs duties that typically range from zero to 25 % (although specific data on how the customs duties apply to capital goods are not available).

Readers should refer to the full country reports, produced as part of this series of studies, as substantive background. The data provided here (taken from the International Bureau of Fiscal Documentation) merely serves to highlight the main characteristics of the different tax systems. The Kenya and Uganda information is provided for comparison purposes only.

Further, various provisions noted in footnotes are listed for completeness only and are not reflected in the comparison country METR calculations.
### Annex C. Comparator Country Tax Incentive Regimes

<table>
<thead>
<tr>
<th>Rwanda</th>
<th>South Africa</th>
<th>Uganda</th>
<th>Kenya</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax incentives</td>
<td>Tax incentives</td>
<td>Tax incentives</td>
<td>Tax incentives</td>
<td>Tax incentives</td>
</tr>
<tr>
<td>Tax holidays available (3 years urban 5 years rural) for micro/small businesses. CIT, VAT, and tariff reductions available in some sectors or in mining, for some individual firms.</td>
<td>Tax holiday for firms incorporated between 1996-1999. Other incentives such as MSSE development program for manufacturing sector firms (up to ZAR 3 million), other MSSE support, and a skills support program. DTI lists 90 different types of fiscal and non-fiscal incentives</td>
<td>Investors can qualify for duty and sales tax drawbacks by satisfying three of the following criteria: the generation of new earnings or savings of foreign exchange through exports, resource-based import substitution or service activities; using local materials, supplies and services; creating employment opportunities in Uganda; introducing advanced technology; contributing to locally or regionally balanced socio-economic development. These drawbacks are also extended with foreign capital investments over USD 500,000 and domestic investments over USD 50,000.</td>
<td>There is no codified investment scheme in Kenya to attract investors, but incentives do exist in the form of various allowances and waivers of import duty, which can be negotiated individually with the Ministry of Finance.</td>
<td>Tax holidays available (3 years urban 5 years rural) for micro/small businesses. CIT, VAT, and tariff reductions available in some sectors or in mining, for some individual firms.</td>
</tr>
<tr>
<td>Corporate income tax</td>
<td>Basic rate: 35%--45% for financial sector in excess of K250 million, ad hoc reductions for some sectors 17.5%, deferments for specific items, VAT only applicable for firms turnover over minimum threshold</td>
<td>Basic rate: 29%, concessional rates for mining and MSSEs</td>
<td>Basic rate: 30%</td>
<td>Basic rate: 30%</td>
</tr>
<tr>
<td>---------------------</td>
<td>---------------------------------------------------------------------------------</td>
<td>---------------------</td>
<td>---------------------</td>
<td>---------------------</td>
</tr>
<tr>
<td>VAT rate (general)</td>
<td>14%</td>
<td>17%</td>
<td>16%</td>
<td>17%</td>
</tr>
</tbody>
</table>

**2. Regional**

| Specific regions with incentives | Rural areas eligible subject to 15% CIT. | Industrial Development Zones offer new investments fiscal incentives. New eligible firms receive tax free status. | Benefits available to EPZ enterprises include exemption for excise duties, exemption from corporation tax and withholding tax for 10 years, exemption from stamp duty, and a 100% investment deduction. | Rural areas eligible subject to 15% CIT. |
### 3. Sector Specific

| Specific sectors with incentives | Mining (copper, cobalt) CIT 25%, agriculture 15%, nontraditional exports, 15%. Capital allowances especially in agriculture, tourism, manufacturing, (50% per annum). Duty exemptions for capital equipment imported by mining company. VAT zero ratings for exports, tour packages. | Capital allowances especially in agriculture, tourism, manufacturing; duty exemptions for capital equipment imported by mining company; VAT zero ratings for exports, tour packages; incentives for motor industry and textiles. | “Priority Areas” include processing of crops, forest products, meat and fish, banking, steel, chemicals, textiles and leather, oil milling, paper, mining, glass and plastic, ceramics, manufacture of tools, equipment and industrial spare parts, construction and building materials manufacture, tourism, real estate development, packaging, transport, energy conservation, pharmaceuticals, and high technology. | A 100% investment deduction is available on the cost of buildings and new machinery used for manufacturing purposes and hotels. | Basic rate: 35%, 25% for mining, 10% for manufacture in growth industries, 20% other manufactures which export, 20% tourism |

1/ Comparator country data obtained during desk study from International Bureau of Fiscal Documentation Country Reports, various years & should be used for reference only. Tanzania information is current as of September 2004 & does not include proposed incentive changes.

2/ All countries in this list have double taxation agreements.
Annex D: TRA Structure

There are at present three revenue departments within the TRA (www.tra.go.tz):

**Domestic Revenue Department (DRD),** which was a merger between the VAT and Income Tax Department in July 2005. Currently, the DRD has a workforce of 1797, of whom 80 are based in the Dar es Salaam headquarters, 1254 in the 24 regional offices, and 463 in the 66 district offices.

**Customs and Excise Department** (import duties, VAT and excise duties on imported goods).

**Large Taxpayers Department** (responsible for assessing, collecting and accounting of all taxes from large taxpayers, including corporate tax, PAYE, withholding taxes, VAT and local excise duty). The LTD was established in 2001. Initially, it was responsible for 98 companies. In FY 2004/05, its coverage had increased to 181 companies. By July 2005, the LTD administers 286 large taxpayers and secures almost 70% of domestic collections. To be included in the LTD, the firm must have an annual turnover of at least TSh 10 billion or a total tax payable of TSh 150 million. Moreover, the finance and banking sectors are managed by the LTD (IMF 2005a:29). By July 2005, the LTD has 85 staff members of whom 38 are auditors (ibid 32).

The **Tax Investigations Department**, supports directly the revenue departments in enforcing the various tax laws through regular investigation of tax cases with substantial amounts of revenue at risk.

In addition, TRA has six support departments:

1. Human Resources and Administration
2. Information Systems
3. Finance
4. Internal Audit
5. Research, Policy and Planning
6. Taxpayer Services and Education.
Annex E: Macroeconomic perspective (or mix of tax instruments)

The strengthening of Tanzania Revenue Authority (TRA) over the last four years is remarkable and is evidenced by a 20% increase in revenue collected per year, from TSH 65 billion in 2000 to about TSH 135 billion in 2004.

Although, the set of tax instrument is consistent with the level of development of the country, Tanzania relies heavily on taxes on goods and services. As shown in Table F1 below, in the period 1998-2004, the share of such taxes in total tax revenue was 51% against 36% in South Africa; perhaps more comparable in 2004, it represented 50% against 41% in Zambia. In contrast, Tanzania is lagging behind in terms of direct tax revenue and in particular personal income tax revenue. For instance, direct tax revenues represented 31% of total tax revenue against 48% in Zambia in 2004. Therefore, a key challenge appear to rest in the expansion the personal income tax base, possibly through the formalization of the large informal sector, or through the promotion of the private business sector.
### Table F1: Tanzania tax instruments and comparison with South Africa and Zambia

<table>
<thead>
<tr>
<th>Year 2003</th>
<th>S. Africa</th>
<th>Rwanda</th>
<th>Zambia</th>
<th>Tanzania</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of tax (%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Direct taxes</td>
<td>59.90</td>
<td>30.60</td>
<td>47.60</td>
<td>29.22</td>
</tr>
<tr>
<td>1.1. Tax on income and profit</td>
<td>57.30</td>
<td>30.00</td>
<td>47.60</td>
<td>29.22</td>
</tr>
<tr>
<td>1.1.1. Companies</td>
<td>18.30</td>
<td>13.70</td>
<td>6.60</td>
<td>7.86</td>
</tr>
<tr>
<td>- Large companies</td>
<td>7.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Small enterprises</td>
<td>3.3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Arrears</td>
<td>3.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.1.2. Individuals</td>
<td>36.9</td>
<td>14.4</td>
<td>37.0</td>
<td>15.93</td>
</tr>
<tr>
<td>1.1.3. Others</td>
<td>2.1</td>
<td>1.9</td>
<td>4.0</td>
<td>5.43</td>
</tr>
<tr>
<td>1.2. Property taxes</td>
<td>2.6</td>
<td>0.6</td>
<td></td>
<td>0.79</td>
</tr>
<tr>
<td>2. Taxes on goods and services</td>
<td>36.0</td>
<td>50.1</td>
<td>41.1</td>
<td>58.61</td>
</tr>
<tr>
<td>2.1. Excise taxes</td>
<td>10.7</td>
<td>14.2</td>
<td>13.0</td>
<td>15.38</td>
</tr>
<tr>
<td>2.2. Turnover tax / VAT</td>
<td>25.3</td>
<td>33.3</td>
<td>28.1</td>
<td>38.61</td>
</tr>
<tr>
<td>of which: on imports</td>
<td>16.9</td>
<td>17.5</td>
<td>22.10</td>
<td></td>
</tr>
<tr>
<td>2.3. Road Fund / Fuel Levy</td>
<td>2.7</td>
<td></td>
<td></td>
<td>4.62</td>
</tr>
<tr>
<td>3. Taxes on international trade</td>
<td>3.3</td>
<td>19.3</td>
<td>11.2</td>
<td>14.48</td>
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<tr>
<td>3.1. Export tax</td>
<td>0.0</td>
<td>0.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>of which coffee</td>
<td>0.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.2. Import tax</td>
<td>3.3</td>
<td>15.7</td>
<td>11.2</td>
<td>9.53</td>
</tr>
<tr>
<td>of which surcharge on sugar</td>
<td></td>
<td>0.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.3. Other</td>
<td>0.8</td>
<td>3.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total tax revenue</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td></td>
<td>99.20</td>
<td>100.00</td>
<td>99.90</td>
<td>102.31</td>
</tr>
<tr>
<td>Grants in percentage of total revenue</td>
<td>0</td>
<td>46.5</td>
<td>17.1</td>
<td>41</td>
</tr>
<tr>
<td>Tax revenue as percentage of GDP, est.</td>
<td>25</td>
<td>14.0</td>
<td>18.0</td>
<td>12.03</td>
</tr>
</tbody>
</table>

*Source: Tanzania Revenue Authority, FIAS aide mémoire on South Africa, and FIAS report on Zambia*
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