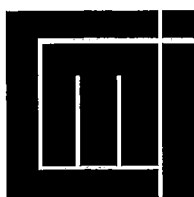


Taxation and Tax Reforms in Tanzania: A Survey

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WP 1995: 4



Working Paper
Chr. Michelsen Institute
Development Studies and Human Rights
Bergen Norway

ISSN 0804-3639

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Bergen, November 1995. 37 pp.

Summary:

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

Sammendrag:

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

Indexing terms:

Taxation
Tax reforms
Tanzania

Stikkord:

Skattlegging
Skattereformer
Tanzania

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1 Introduction and overview¹

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

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

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

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

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

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

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

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

2 The tax system in Tanzania

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

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

2.1 Background for tax reform

1. Income per capita and income distribution.

Tanzania is one of the poorest countries in the world, with a population of roughly 28 million, growing at 3 percent per year, and covering the eight largest land area (945,000 square km) in Sub-Saharan Africa (World Bank, 1995b). Per capita income was estimated to USD 90 in 1993, and average annual GNP growth per capita during the period 1980-1993 was estimated to 0.1 percent (World Bank,

1995a).⁴ Poverty is widespread with about half the population below the poverty line (Ferreira, 1993).⁵ Income distribution is distorted. In 1991, the highest 10 percent fractile of persons, ranked by per capita expenditures, received more than 45 percent of national income, and the lowest 20 percent fractile received roughly 2.5 percent (Mans, 1994). Thus, the scope for extensive reliance on personal income taxation is limited. While, in principle, the rich could have paid a high level of tax on income, the necessary administrative apparatus required for enforcement and collection does probably not exist, and if it did, would probably not be cost efficient. Moreover, economic distortions are likely to arise if very high income tax rates were imposed.

2. *The agriculture sector.*

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

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

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

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

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

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

3. The formal and informal sectors.

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

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

4. The public sector.

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

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

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

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

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

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

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

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

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

2.2 *The structure of the tax system*

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

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

Table 2.1

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

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

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

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

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

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

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

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

Indirect taxes.

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

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

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

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

section 4). During FY 1993/94 and 1994/95 tax revenues from these bases have stayed almost at the 1992/93 level relative to total tax revenues and GDP.

Direct taxes.

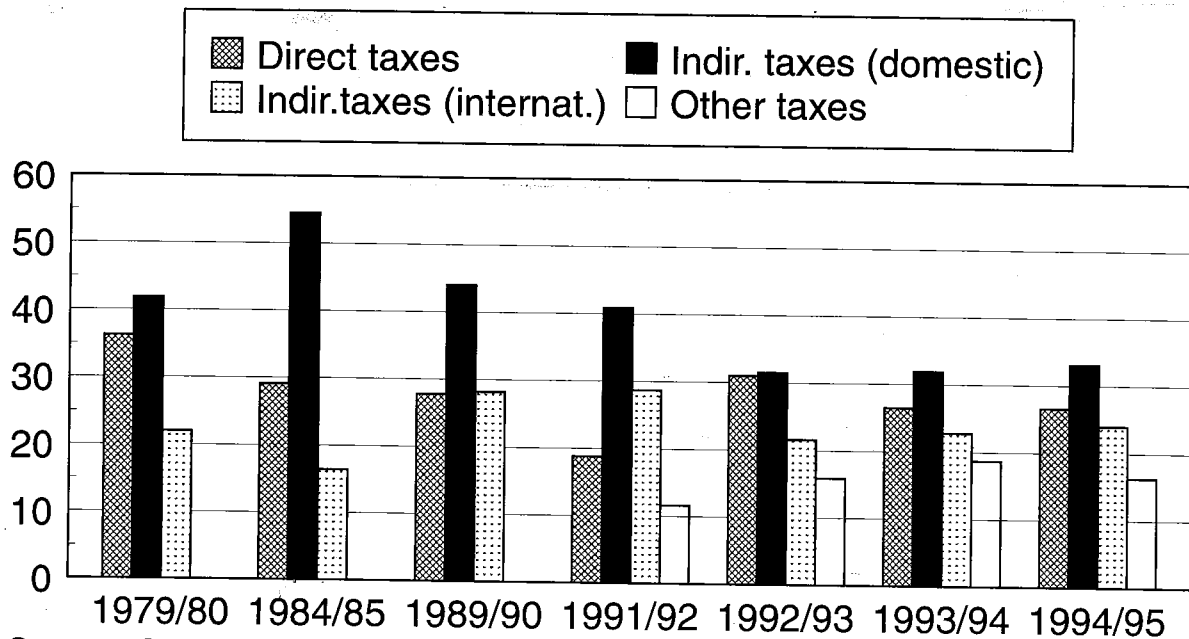
The following facts emerge from Tables 2.1 and 2.2:

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

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

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

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



Sources: See table 2.1

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

3 Tax reforms in Tanzania

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

3.1 A brief history of tax reforms in Tanzania

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

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

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

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

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

3.2 The Tax Commission's recommendations

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

Direct taxes

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

¹² See also section 5.

Indirect taxes

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

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

Personal income taxes

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

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

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

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

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

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

Company income taxes

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

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

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

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

inflation causes a reduction of real tax revenue because of lags in tax collection, and because it forms the base of the inflation tax (see Tanzi, 1987:238).¹⁷ They also distort the efficiency and equity of the explicit tax system (Lindbeck, 1990:67). In the case of company taxation, inflation may result in severe and undesirable distortions in investment incentives, company accounting, and tax liability. Recognizing this problem, the Tax Commission recommended that when inflation is high (in double digits), accelerated depreciation (up to 100 percent) should be given on machinery and equipment (URT, 1991a:para 7.48). However, no mention is made of the distortion resulting from the deduction of nominal interest (including the inflation component), nor is any quantitative analysis of the revenue implications of this recommendation presented. The issues of inflation and investment incentives raised above are, however, complex and controversial.

Indirect taxes

Most of the Commission's recommendations that can be quantified with respect to the more important indirect taxes, will most likely imply a loss of tax revenues:

- Excises should be confined to a narrow range of goods such as alcoholic drinks, beverages, soft drinks, tobacco and petroleum, cosmetics, jewellery, etc. Textiles would cease to be liable to excise duty, so should duties on sugar and soap.
- Customs duty should be simplified to three rates: zero for capital and essential goods; 20 or 25 percent for intermediate inputs; and 30 or 40 percent for consumer goods.
- Export-duties should not be re-imposed for the foreseeable future.

The Commission is, however, rather vague as to the revenue implications of its indirect tax proposals (URT, 1991a:para. 24.20), apparently because of the uncertainty related to the final rate structure and the extent to which exemptions would be eliminated. The replacement of the present sales tax by a value-added-tax (VAT) is the Tax Commission's central recommendation in this area (URT, 1991a:para. 12.5, para 12.19 and para 12.36). It seems clear that the Tax Commission envisages the VAT, and its potential future expansions, as an essential part of Tanzania's future revenue system. The tax base would initially be similar to the present sales tax, with some additional services being subject to taxation at the 10 percent rate. There would be no exemption for small firms.¹⁸ At the same time, many of the existing excise taxes, notably on textiles, would be abolished (URT, 1991a:para. 13.15) - as has now been done for locally produced

¹⁷ This is the well-known Olivera-Tanzi effect. In this paper I do not discuss the inflation tax, which is somewhat different from other taxes in that it is not levied formally, and revenue can also be zero or even negative (if prices are falling). For a few countries with persistent inflation this tax is likely to be a significant source of revenue (Bleaney et al., 1995:891).

¹⁸ Introduction of a VAT in Tanzania is discussed in more detail in Fjeldstad (1995b).

textiles. In addition, the Commission recommended that the existing "discretionary" exemptions from sales and excise taxes, like those on customs duties, should be abolished (URT, 1991a:para. 12.24).

3.3 Implementation of the Tax Commission's recommendations

Consistent with the recommendations of the Tax Commission, various taxes were simplified, and a number of tax rates were lowered in the FY 1992/93 budget. It was expected that these measures would yield additional revenue that would more than offset the anticipated decline in revenue due to the tax rate reductions (World Bank, 1994a). In brief, the Government has implemented (or intend to implement) the following tax reforms:¹⁹

- All types of tax and duty exemptions granted to the central and local governments, religious institutions (exemptions should be limited to "goods" for pure religious rituals), parastatals, political parties and their affiliates were abolished in June 1992.
- The personal income tax rates were reduced to a range of 5 to 30 percent from the range of 7.5 to 40 percent in July 1992.
- The corporate income tax rates for resident companies were reduced to 35 percent from 45, and for non-resident companies from 50 to 40 percent in January 1993.
- The rate structure of customs duty were changed in FY 1992/93 from the existing rates (in percent) 0, 20, 30, 40 and 60 to 0, 10, 20 and 30. A new customs classification system was also introduced.
- A customs duty of 20 percent for lubricants is intended to be introduced.
- All excise tax rates above 20 percent were lowered to that level, and locally produced sugar, soap, textiles and other commodities were exempted from excises in FY 1992/93. Further, all taxes on raw materials for use by local industries are to be remitted i.e. free of customs duties, sales tax and excise duties. Certain taxes - particularly sales tax and excise duties - on certain food items, e.g., sugar, wheat flour, etc., are to be removed.
- The land rent is to be increased by 20 percent after a revaluation of all land properties.
- The road toll was increased from TSh 7 to TSh 10 per litre of diesel or petrol.
- The airport services tax of USD 20 is extended to be charged for all departures for external destinations for both resident and non-resident travellers.
- All taxpayers shall file an income tax return.

There are, however, major shortcomings in the implementation of the recommended measures to widen the tax base. In fact, tax exemptions, far from being eliminated, have increased. In September 1993, for example, less than 10

¹⁹ From Table III in United Republic of Tanzania (1992d).

percent of import taxes payable under the preshipment inspection and tax assessment programme had actually been paid (World Bank, 1994a:8).²⁰ Exemptions for imported inputs which were enacted in the 1992/93 budget, were therefore cancelled in 1993 because of severe difficulties with evasion and avoidance. A major problem in this respect was to distinguish imported inputs from imported goods.

The two major base broadening measures recommended by the Tax Commission, i.e. the introduction of a VAT and to incorporate into the tax base all monetary allowances and fringe benefits paid to formal sector employees, have yet to be implemented. In the short run, it is also unrealistic to expect all taxpayers' to file an income tax return. The Government announced in the 1992 (June) Budget Speech its intention to replace the existing sales tax with a VAT in January 1994. To this day, however, little progress has been made in this area. Given the substantial amount of lead time required to make a VAT fully operational, 18-24 months is often indicated, the earliest that it will be possible to introduce the VAT would be by mid-1997 (Fjeldstad, 1995b). This presupposes that intensified efforts are made to launch the preparations immediately. Regarding the second major base-broadening measure, the widening of the income tax base, little progress has been made here, too (World Bank, 1994a:9).

Tanzania currently depends on indirect taxes for more than two thirds of its total tax revenue (see Table 2.1 and 2.2). A successful implementation of the proposed reforms will probably not change this situation. On the whole, the changes in tax mix that would result from implementing the Tax Commission's recommendations - more revenues from indirect taxes, and relatively less direct tax revenues from companies and more from individuals - all seem justifiable in Tanzania's present circumstances. However, the delays in introducing a VAT illustrate that implementing the reforms is a more problematic task than indicated in the Commission's report.

4 The revenue shortfall in fiscal year 1992/93

During FY 1992/93 Tanzania experienced a significant fall in tax revenues collected, both in relation to the budgeted figures and compared to the revenues collected in the previous four year period. Figure 4.1 and 4.2 illustrate the revenue reduction in relation to GDP. Tax revenue in percent of GDP was reduced from an annual average of more than 19 percent in the previous four year period, to 11.5 percent for FY 1992/93. The drop was mainly due to reduced tax revenue from sales and excise taxes and import duties (Figure 4.2). Revenues from sales and excise taxes fell to 3.6 percent in FY 1992/93 from an annual average of 10 percent of GDP in the previous four-year period.

²⁰ This is discussed in more detail in section 4.1.

Figure 4.1
 Central government tax revenue and expenditure, 1985-95
 (in percent of GDP)

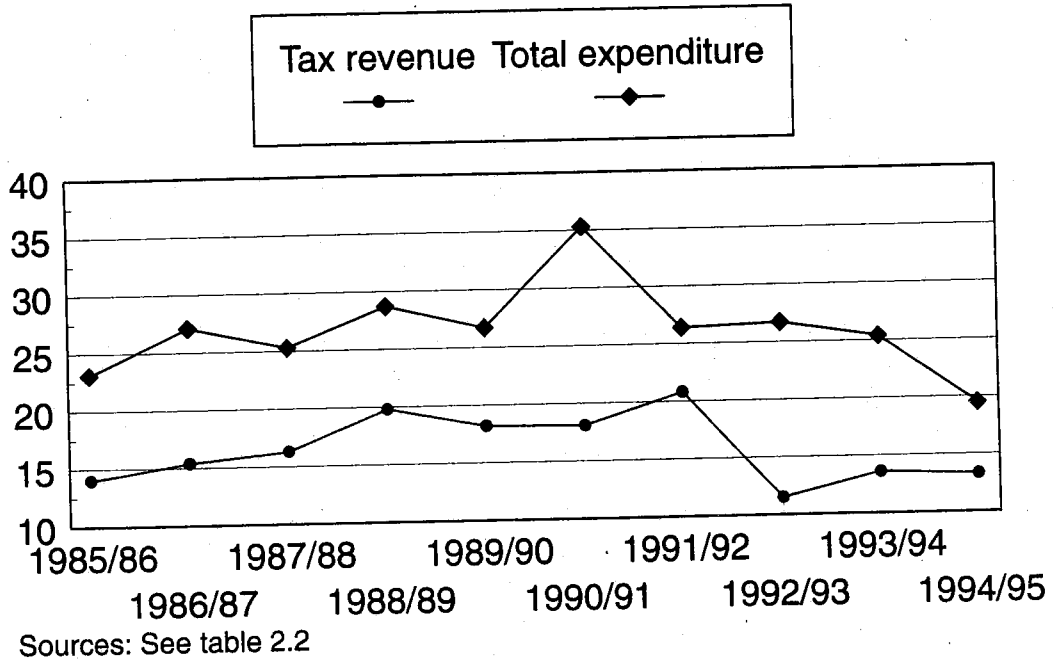
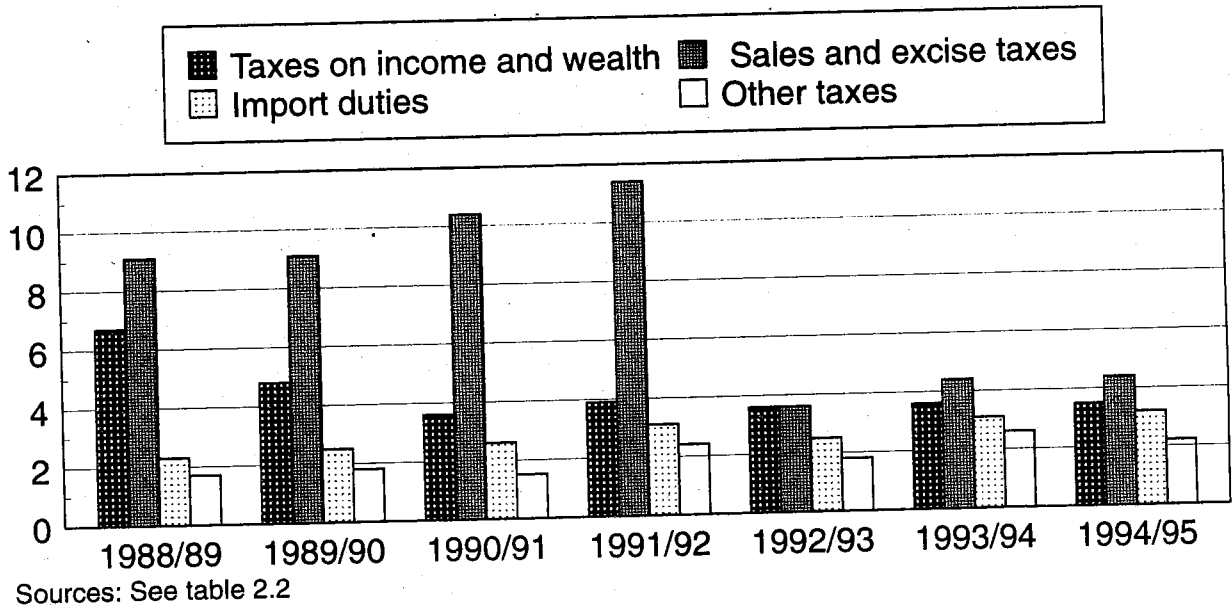


Figure 4.2
 Central government tax revenue, 1988-95
 (in percent of GDP)



4.1 Factors explaining the drop in tax revenue

A combination of several factors explain the drop in tax revenue in FY 1992/93:

- (a) immediate revenue losses owing to (1) *reduced tax rates* not offset by a sufficient reduction in (2) *exemptions* and the assumed reduction in (3) *tax evasion and avoidance*; and
- (b) the fact that the required strengthening of (4) *tax administration* to follow up the tax reforms, has proved difficult to implement in the short term.

(1) *Reduced tax rates*

During FY 1992/93 the following tax reductions were introduced (URT, 1992b:para 60-63):

- the personal income tax rates were reduced to a range of 5 to 30 percent from the range of 7.5 to 40 percent;
- the corporate income tax rates were reduced for resident companies to 35 percent from 45, and for non-resident companies from 50 to 40 percent;
- the rate structure of customs duty was changed from the existing rates (in percent) 0, 20, 30, 40 and 60 to 0, 10, 20 and 30;
- all excise tax rates above 20 percent were lowered to that level and locally produced sugar, soap, textiles and other commodities were exempted from excise; and
- all industrial raw materials were exempted from customs duty and sales tax.

These reforms were in line with the recommendations made by the Tax Commission. It was considered that high tax rates in the past had adversely affected productivity in the industries, which in turn led to increased operational overheads and thus affected the competitiveness of locally produced commodities vis a vis imports (URT, 1992b:para 57).

However, the major reductions in tax rates were implemented without de facto and de jure broadening the tax base. In other words, only one element of the "low-rate, broad-base" strategy was followed (see section 3). I have not been able to provide sufficient information for estimating the likely revenue loss due to the various tax rate reductions, but I would expect the losses to be significant.²¹

(2) *Tax exemptions*

Much tax revenue has been lost through exemptions. For instance, the exemptions granted on imports in 1989 constituted more than 96 percent of the potential taxes on these imports (World Bank, 1992:29). According to URT (1992b:para 65), all types of tax and duty exemptions granted to the central government, local governments, political parties, and commercial enterprises were abolished from

²¹ Relevant information is, for instance, updated estimates on the elasticity and buoyancy of the various taxes (see section 5.2).

June 1992. The Government expected revenue to increase by TSh 9,850 million due to the abolition of tax exemptions - a far too optimistic estimate. In addition, the abolishment of these exemptions was only partly implemented, and there are still many loopholes in the system.

(3) Tax evasion and avoidance

An endemic problem in the Tanzanian tax system is tax evasion, which appears to be substantial and widespread (see section 5.4). The Government expected that reduced rates would contribute to reduced tax evasion (URT, 1992b:para 58). However, it is not prudent to include such revenues in budgetary estimates, particularly when there is little reason to expect them to be realized.

A major problem in this respect is undervaluation of imported goods, which applies to most own-funds imports. This is due to the fact that the importer has access to foreign exchange without going through Bank of Tanzania records. Central Bank funded imports (where the importer offers local currency in exchange for foreign), as well as government and parastatal imports, are in general easier to value, but are often exempted from taxation. Administrative constraints and corruption at entry points increase the problem of undervaluation of imported goods (Basu and Morrissey, 1993:22).

As a measure to reduce undervaluation, pre-shipment inspection (PSI) was introduced in October 1992. On behalf of Bank of Tanzania, the Government engaged the international companies, the Société Generale de Surveillance (SGS), Contecna and SSI, to inspect shipments to Tanzania from ports abroad.²² The PSI programme involves inspection of imports to Tanzania in the country of exportation, together with an assessment of the invoice price of the goods to be imported. The purpose of the pre-shipment inspection is to ensure that the foreign exchange outlay is commensurate with the price, quality and quantity of the goods being imported.²³ This measure must be considered as a short-run solution to the basic problem of unsystematic and unreliable import valuation. In FY 1992/93 the pre-shipment inspection companies were empowered to assess the amount of duty payable at the time of inspection of imports. The intention was to reduce bureaucracy and tax evasion. In the case of imports financed by Bank of Tanzania's foreign exchange, values are pre-checked at the point of shipment. The minimum value of the shipments controlled was originally set to USD 5,000. By February 1993 the pre-shipment inspection was extended to include "own funded" imports over USD 5,000, to check that these imports were not under-valued.

²² The SGS does both pre-shipment control and tax assessment, the SSI makes pre-shipment control, and Contechna assesses taxes.

²³ Low (1995) provides a thorough discussion of the principles and practice of pre-shipment services.

However, the minimum value of the shipments controlled (USD 5,000), gave importers incentive to split their shipments into units each valued below the minimum limit, and thereby avoiding the control. There are also indications that Zanzibar's position as a "freeport" to some extent has contributed to the avoidance of import duties. Lower (or to some extent zero) rates on goods imported to Zanzibar, led many importers to let their imports pass through Zanzibar, and then "re-import" these goods to the mainland.²⁴ Thus, by splitting the import shipments into units valued below the USD 5,000 limit, and by importing via Zanzibar, importers could effectively avoid taxes.

The revenue loss due to this kind of tax avoidance is difficult to assess in quantitative terms. It is, however, reasonable to assume the loss to be significant since the Government has considered it necessary to reduce the limit of pre-shipment control to USD 2,500. Further, from January 1993, importers shall (in principle) pay the difference in tariffs if imported goods enter the mainland through Zanzibar.

(4) Tax administration

The 1992/93 budget estimates seem to depend to some extent on increases in direct tax revenues from improved administrative measures in tax collection and an extended tax base. According to the budgetary figures for 1992/93 Tsh 1,808 million was to come from improved measures in tax collection (URT, 1992b:para 92). Taxes on income and wealth did increase as share of total tax revenue in FY 1992/93, due to reduced tax revenue from the other major tax sources (see Table 2.1). However, measured in percent of GDP income tax revenue was in fact reduced compared to previous years.

The Government has taken several efforts to improve tax administration, and these efforts may have contributed to some extent to a more efficient tax administration during the last few years. The tax administration was also capable of collecting a significantly higher amount of revenues (both in absolute and relative terms) in FY 1991/92 than in the preceding years (see Figure 4.2). In FY 1992/93 new tax rates and new procedures for collecting tax revenues were introduced. Such measures are usually difficult to implement in the short run without being supplemented by a considerable strengthening of tax administration, otherwise the administration may not manage to adopt the new system in a proper way. This factor probably plays a major role in explaining the revenue shortfall in fiscal 1992/93, although difficult to quantify.

²⁴ The Dar es Salaam Express (14 January 1993), for instance, reports on the problem of importers routing goods through Zanzibar, where tariffs are lower, e.g., 20 percent on TVs, compared to 40 percent in mainland Tanzania; 13 percent on textiles, compared to 20 percent, respectively.

4.2 Lessons to be learned

The drop in tax revenues experienced in FY 1992/93 is not unique. Experience from other developing countries shows that structural economic reforms often entail short-run revenue losses (IMF, 1992). Empirical studies also show that fiscal revenues, in general, tend to exhibit greater variability in less developed countries than in developed market economies (Bleaney et al., 1995).²⁵ These differences seem to reflect characteristics of the economy such as inflation, output variability and openness.

A widespread objective of tax reforms in many low income countries has been to shift from reliance on taxation of imports (and exports) to domestic taxation by broadening the tax base - by introducing value-added taxation and extending the individual income tax base. This objective has been pursued in line with trade liberalization and the need to promote productive efficiency by reducing the level of effective protection. Although (and more unusually) Tanzania's indirect tax structure is dominated by taxes on domestic goods and services rather than on imports, taxes on international transactions are not likely to increase significantly in the coming years, and may even grow less than GDP (see section 5.4).

Broadening the domestic tax net to a larger commodity and income tax base requires substantial strengthening of tax administration, which has proved to be difficult to implement in the short term. Achieving increased revenues from such a change assumes that the administration responsible for collecting domestic taxes from an extended base are able to enforce these taxes. This is, in general, a much more difficult task than collecting tariffs from a more limited customs space. Hence, when tariff rates are reduced, without an accompanying removal of tax exemptions and a strengthening of tax administration, revenue will immediately be reduced.

The reductions in tax rates during FY 1992/93 were premature, since they were introduced without widening the tax base. This is probably the major explanatory factor behind the shortfall of revenues. A tempting solution to this dilemma would be to increase the tax rates again, for instance to the level before the reductions. However, this may prove to be a shortsighted solution. Frequent changes in tax policy may contribute to increased uncertainty in the business community (including potential foreign investors), and may call into question the credibility

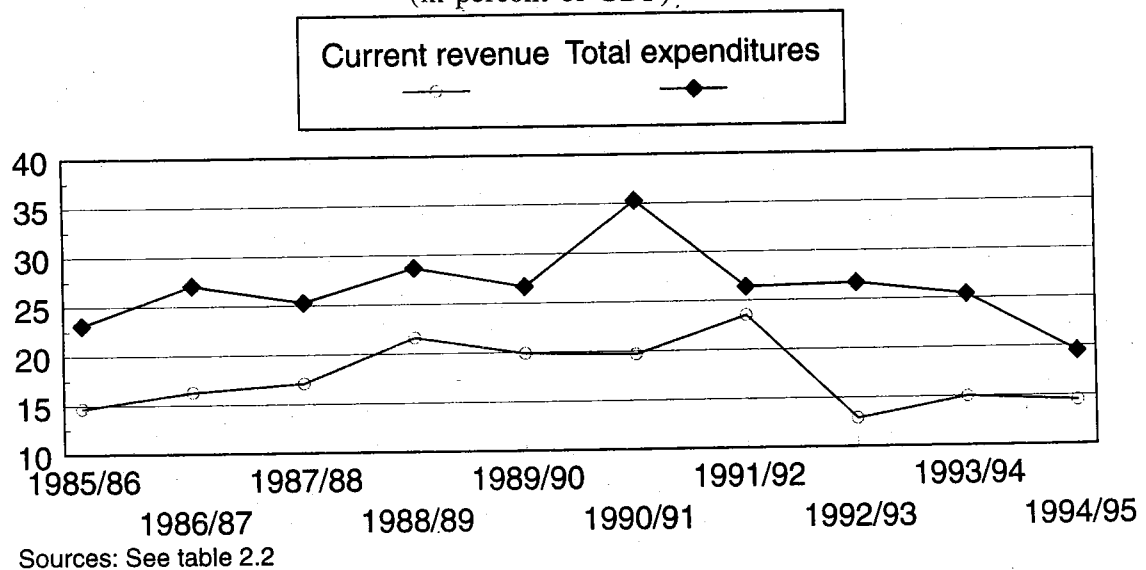
²⁵ A relevant question in this respect would be: Is there a positive correlation between revenue and expenditure instability? It is not clear *a priori* that such a correlation is to be expected. Firstly, if most of the variation in tax revenue is recognised by the Government to be caused by temporary shocks, expenditure is not likely to follow actual revenue closely but to be based on the permanent component of revenue. Secondly, the Government will probably assess the economic and/or political costs of replacing lost revenues with alternative sources of funds compared to the costs associated with expenditure cuts. Such an exercise could then produce different outcomes, for instance, spending cuts, new and/or higher tax rates, increased borrowing, etc..

of the Government's policy. On the other hand, a stable tax policy environment may encourage the business community to take a longer-term perspective in their finance and investment decisions. Tax changes should therefore be made after transitional arrangements have been adequately considered, and they should be presented as part of a long-term strategy. However, due to the decrease in tax revenue collection, the Government decided to reimpose several tax rates and also introduce new taxes on some items in FY 1993/94. It also resorted to bank borrowing to finance its deficits, resulting in continued high inflation.

5 The revenue productivity of the Tanzanian tax system; implications for fiscal self-reliance

The facts presented in sections 2, 3 and 4 are mirrored in the continuing difficult situation of public sector finances. During the five year period from 1987/88 to 1991/92, the annual deficit of the central Government averaged nearly 10 percent of GDP (grants and commodity aid exempted, Table 2.2 and Figure 5.1).²⁶ In 1991/92, the deficit fell to 2.9 percent of GDP reflecting an increase in foreign funded capital expenditures and improvement in revenue collection. The deficit increased to roughly 14 percent of GDP in FY 1992/93 and 10 percent in FY 1993/94, partly due to shortcomings in the attempt to reform the tax system. The estimated deficit for FY 1994/95 is 5 percent of GDP, mainly reflecting reductions in the expenditure budget. However, this estimate should be considered with caution, and may appear to be too optimistic.

Figure 5.1
Central government current revenue and expenditure 1985-95
(in percent of GDP)



²⁶ See also Table B7 in URT (1992a).

5.1 Tax revenue in percent of GDP

The level of tax revenue (T), expressed as a percentage of gross domestic product (T/GDP), varies considerably among developing countries. In some countries, it is below 10 percent and in a few it is above 30 percent. For the majority of developing countries the level ranges between 15 percent and 25 percent.²⁷ Compared to other low-income countries with a large share of agriculture in GDP, tax revenue collection in Tanzania is high.²⁸ The average tax ratio (total tax revenue as a share of GDP) for the countries in Figure 5.2 is 10.6 percent.²⁹ In comparison, Tanzania's tax ratio was 18.1 percent in FY 1990/91, which is equivalent to developing countries in which the agriculture sector's share of GDP is in the area 25-30 percent, such as Gambia, Kenya and Sri Lanka. For instance, in FY 1990/91 the tax ratio of Gambia was 25.8 percent, Kenya 17.8 percent and Sri Lanka 19.1 percent (IMF, 1992).

Even if the Tanzanian GDP figures were underestimated by 50 percent as indicated by a recent study (World Bank, 1995b), and GDP is not underestimated in the other countries included in the figure (which is unlikely), revenue collection in Tanzania would still be above average (12.3 percent).³⁰ Underestimation of GDP figures is probably also the case for most of the other countries listed in Figure 5.2. The ranking of Tanzania in the table would therefore not necessarily be affected by more "realistic" GDP figures.

Since 1992 Tanzania's tax ratio has dropped to a level almost corresponding to the other countries in the figure (11.5 percent in FY 1992/93; 13.6 percent and 13.3 percent in FY 1993/94 and 1994/95, respectively). However, one should take into consideration that Tanzania has the highest share of agriculture to GDP (about 50 percent) of the selected countries.

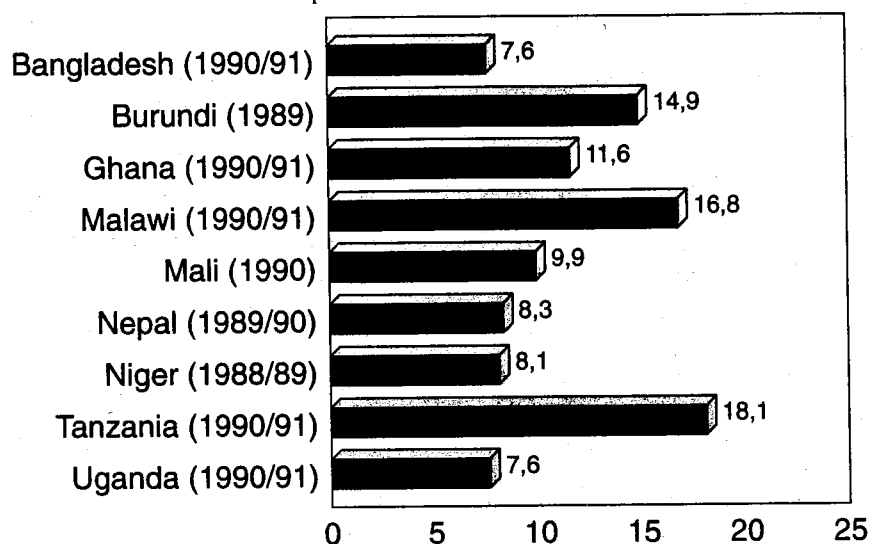
²⁷ For the OECD countries the average in the 1980-85 period was between 35% and 37% of GDP. In a few countries (Belgium, Denmark, France, The Netherlands, Norway and Sweden) in 1985 it exceeded 45% of GDP (Tanzi, 1991).

²⁸ The countries included in Figure 5.2 are selected on the basis that agriculture constitutes more than 30 percent of GDP. In Tanzania, the share of agriculture in GDP is about 50 percent.

²⁹ This average figure should be considered with caution and only be seen as an indication of the level of tax revenue to GDP ratio, since the reference year varies among the countries.

³⁰ Due to the existence of a sizeable sector of unrecorded domestic and international economic transactions (see section 2.1), it is assumed that the GDP figures underestimate the size of the real total economy in Tanzania. This is the background for the upward adjustment of the GDP figures by 10-12 percent in 1995. This adjustment was, however, significantly lower than the upward adjustment recommended by the IMF (personal communication).

Figure 5.2
Tax revenue in percent of GDP in selected countries



Source: IMF (1992)

5.2 Measuring the tax system's revenue productivity

One criteria of an appropriate tax system is a high revenue productivity. The effect on revenue has also been the principal issue for the Tanzanian tax reforms (Osoro, 1992b; and section 3). The common measures of such productivity are *buoyancy* and *elasticity* (Osoro, 1992a:395).³¹ Two factors can cause gross tax revenue to rise:

- the rate of tax and legislations can be changed to raise more revenue from the same base; or
- the base on which the tax is imposed may grow.

The growth of tax revenues in response to GDP can therefore be decomposed into two components:³²

1. the automatic growth as the base on which the tax is charged grows in response to GDP; and

³¹ The method applied for estimating buoyancy and elasticity requires detailed knowledge of the country in case, and is typically very crude - such as using dummy variables (for years in which tax parameters are known to have changed) in a regression of tax revenues on time. See, e.g., Bleaney et al. (1995:886) for a discussion of measurement problems in empirical analysis of tax changes (and revenue instability) in developing countries.

³² Tax compliance is implicitly included in the first component. In addition, the composition of growth in GDP matters.

2. the growth resulting from changing the structure of taxes (e.g. the number or level of tax rates, exemptions or the tax coverage).

The combined effects of 1 and 2, i.e. the total revenue response, is termed *tax buoyancy*. A buoyancy coefficient of, for example, 1.4 would imply that for every 1 percent increase in GDP, revenue from the tax had on average grown by 1.4 percent. The amount by which revenue from a tax, with a given structure, changes in response to a change in its base, i.e. the effect of automatic growth alone (point 1 above), abstracting from discretionary changes, is termed the *elasticity* of a tax. Thus, the elasticity of the tax system is how revenue from an unaltered tax structure responds to economic growth. Hence, for an individual tax or the tax system, the difference between the buoyancy (total response), and elasticity (automatic response) can be attributed to structural changes. Accordingly, an elasticity coefficient of 1.4 would imply that for every 1 percent increase in GDP, tax revenue would have grown by 1.4 percent if the legislation and rate of tax had remained unchanged (Osoro, 1992a:396). An elasticity of at least unity is a desirable property of a tax (system). Its revenue growth will then keep pace with that of GDP without frequent discretionary changes having to be made to its rates and structure.

Elasticities of the total tax system and of major individual taxes are presented in Table 5.1. First, the elasticity of the total system was less than unity (0.80) over the 1979-89 period, indicating that for every 1 percent increase in GDP, total tax revenue would have grown by 0.80 percent in the 1980s. A buoyancy higher than unity (1.03) indicates that it was the tax reforms (see section 3.1) that generated any overall revenue increases. Second, personal income tax had an elasticity of 0.81 and buoyancy of almost unity (0.96). Consequently, increases in income tax revenues were mainly generated by tax reforms. This was also the case with company tax and PAYE (see section 2.2) which had elasticities of 0.90 and 0.68, and buoyancies of 0.9 and 0.96, respectively. Third, sales tax had a buoyancy of almost unity (0.96) and an elasticity of 0.73, indicating that any revenue increases were generated by tax reforms. Osoro (1992a:405) has estimated the sales tax-to-base elasticity to 0.5,³³ indicating the degree of revenue loss due to tax exemptions, tax evasion and avoidance. Fourth, import duty had an elasticity of 0.97 and a tax buoyancy of 1.27, indicating that tariff changes were the principal source of increased revenue. Further, a tax-to-base elasticity estimated to 0.9, suggests a relatively efficient import tax collection during this period (Osoro, 1992a).³⁴ Finally, regarding the buoyancy coefficient of 1.03 of the total system,

³³ Tax-to-base elasticity measures the direct response of tax revenue to a change in the tax base. The figure is average for the period 1979-89.

³⁴ This situation seems to have changed dramatically in recent years. In September 1993, for instance, less than 10 percent of import taxes payable under the pre-shipment inspection programme had actually been paid. On several occasions, the Auditor General has highlighted cases of negligence and dishonest practices by high placed civil servants (see section 5.4).

this coefficient had probably been much lower without the frequent increases in tax rates or devaluation episodes. A major effort seems therefore to be required to sustain revenue yields in the face of the changing economic circumstances, let alone to raise the share of taxation in the GDP.

Table 5.1
Tax buoyancy and elasticity, 1979-89

	Buoyancy	Elasticity
Total taxes	1.03	0.80
Income taxes	0.96	0.81
Company tax	0.90	0.90
PAYE	0.68	0.68
Sales tax	0.96	0.73
Import duty	1.27	0.97

Source: Osoro (1992a)

5.3 *Fiscal self-reliance*

The success of a country's fiscal policy may be assessed in terms of the extent to which it can meet its expenditures out of its own revenues. A reasonable aim may be to reduce to the point of elimination the current high dependency on foreign aid for budgetary support. In the 1991/92 budget, for example, 39 percent of total recurrent expenditures and more than 90 percent of the development (investment) budget were provided by counterpart funds generated by balance of payments support (Mans, 1994).³⁵ Thus, at least three distinct aspects need to be considered in relation to fiscal self-reliance:

- (a) the level of tax revenues,
- (b) the level of expenditures, and
- (c) the difference between the two ($c=a-b$), or the deficit.

Further, fiscal self-reliance has two dimensions:

³⁵ In recent years, official exports have financed only about one-third of imports.

- (1) A static dimension, which has to do with the present relation between the expenditure and revenue levels; and
- (2) a dynamic dimension, which has to do with the relation between the projected growth rates of revenues, expenditures and GDP.

The Government of Tanzania seems to focus on the latter, setting as a target to achieve a growth rate of public expenditures not greater than that of real GDP.³⁶ If the elasticity of expenditures is unity (i.e. a one percent increase in GDP leads to a one percent increase in expenditures), and the initial starting point is as far from "static" fiscal self-reliance as is the case at present in Tanzania, increased fiscal self-reliance would require an elasticity of revenue with respect to GDP which is greater than unity. According to Osoro (1990), Tanzania has not had unitary tax revenue elasticities in the last two decades. Alternatively, if the target is to ensure that revenues and expenditures grow at approximately the same rate in the future, a major effort must be made initially to lower expenditures, raise revenues, or both, in order to reduce the present large fiscal imbalance and hence the dependence of foreign aid.

5.4 The realism of the fiscal self-reliance objective

The mismatch between revenues (exclusive grants) and expenditures is revealed in Table 2.2 and Figure 5.1. In FY 1991/92 the Government maintained a tight fiscal stance and as a result generated a fiscal surplus after grants. Results for FY 1992/93 show that the fiscal position has deteriorated severely (see section 4). Current revenues fell from 23.5 percent of GDP in FY 1991/92 to 12.9 percent in FY 1992/93, a fall of 10.6 percent in one year. The FY 1992/93 fiscal outcome eroded the gains made in revenue enhancement during the economic reform period after 1986, when revenues increased from 14.7 percent of GDP in FY 1985/86 to 23.5 percent in FY 1991/92. Over the same period expenditures have grown from 23.1 percent of GDP to 26.4 percent, respectively.

After the deficit in FY 1992/93 measures were adopted in the FY 1993/94 budget that aimed to enhance revenue collection and to reduce the deficit back to more sustainable levels (World Bank, 1994a:7). Data for FY 1993/94 and 1994/95 indicate that the revenue enhancement measures adopted in the 1993/94 budget have succeeded in reversing the decline in revenue collection experienced the preceding year, but not managed in regaining the pre-1992/93 level of tax revenue relative to GDP. To finance its activities due to the decrease in revenue collection, the Government resorted in FY 1993/94 to bank borrowing, from the Central Bank

³⁶ In fact, recently the target of a growth rate of expenditures less than that of real GDP has been discussed (personal communications).

and from the commercial banks. This contributed to continuing high levels of inflation and to a credit squeeze on the private sector (World Bank, 1994a:7).³⁷

Reports by two of the pre-shipment companies responsible for checking imports through customs revealed losses of revenues to the State, in the shape of unpaid customs dues, amounting to TSh 70 billion (USD 134.5 million) in FY 1993/94.³⁸ The report stated that a few importers account for a large proportion of taxes unpaid. The number of tax exemptions granted between January and October 1994 totalled 2,400 representing a loss of revenue for the Government of TSh 32 billion (USD 61.5 million). The inquiry into this matter by the Auditor General highlights cases of negligence and dishonest practices by high placed civil servants. In September 1993, for example, less than 10 percent of import taxes payable under the pre-shipment inspection/tax assessment programme had actually been paid (World Bank, 1994a).³⁹ To control goods which are shipped via Zanzibar to avoid taxes, the central Government has signed an agreement with the Zanzibar authorities to set up a inspection company in Zanzibar port.⁴⁰ However, to date this contract has yet to be translated into action (see section 4.1).

Recognizing the serious deterioration in the fiscal situation, in January 1994 the Government adopted a package of revenue measures that included the reimposition of a 10 percent customs duty on all imported raw materials for locally manufactured goods, inclusion of the excise tax in the sales tax base of locally produced goods, strict adherence to preshipment inspection, immediate withdrawal of the concession allowing staggered payment of taxes combined with renewed efforts to collect arrears that had resulted from this concession, strict monitoring of the bonded warehouses, and a review of tax exemptions with a view to decreasing their number. New taxes included a surtax on cars, an increase in the transport withholding tax, an increase in the customs duty on all imported commodities which are also produced locally, and an increase in a number of customs fees and penalties. Some measures were also taken at the expenditure side, but the emphasis was on the revenue side (World Bank, 1994a).

Taxation on international transactions will probably still contribute significantly to total revenue, ranging from 20-25 percent of total tax revenues in the three foregoing fiscal years (see Table 2.1). In a period of economic transition import

³⁷ From an analytical point of view, an interesting issue which arises here is that of Ricardian equivalence. Because increased domestic borrowing implies a commitment to future tax obligations, domestic borrowing may have output effects which are little different to changes in government expenditure.

³⁸ Indian Ocean Newsletter (1994a:5) and (1994c:1).

³⁹ Indian Ocean Newsletter (1994b:5) reports that the Government appears to collect little more than 20-30 percent of all customs dues.

⁴⁰ Indian Ocean Newsletter (1995:1 and 6). The alternative of charging the same duties on imports to Zanzibar as to the mainland, are also discussed (personal communication).

duties may also buy time for the government to reconstruct the domestic tax system. However, the level of import in the last two fiscal years, which has resulted in a certain increase in the share of taxes coming from imports, cannot be relied upon as a permanent source of governmental revenue. In accordance with less reliable import support funds and foreign aid, imports are likely to grow less than GDP. Therefore, import taxes are likely to grow less than GDP as well. This can be counterbalanced in the short run by reducing the extent of tax evasion and exemptions. However, evidence from other developing countries suggests that it becomes difficult to raise additional revenue when the tax revenue/GDP ratio has reached about 20 percent. Therefore, and because a heavy tax burden may be counterproductive and/or in conflict with the GATT agreement or any other international commitments such as SADC and PTA, there is a need to carefully review revenue measures.

Increased tax effort and careful review and substantial curtailment of expenditures in almost all spheres of government activity are needed. An improved tax system, including more efficient tax enforcement mechanisms, may contribute to a greater degree of fiscal self-reliance. However, in the long run it is probably impossible for a poor country like Tanzania to sustain the existing large level of the public sector. In this perspective, the real budgetary problem in Tanzania is that the level of public sector expenditures is well above the realistic capacity of the country to finance them. It is therefore hard to imagine that serious progress can be made without expenditure cuts.

6 Conclusions and policy proposals

The tax base in Tanzania tends to be narrow, excluding relatively important sectors in the economy that are not fully monetized or incorporated in the formal economy, such as large segments of agriculture, small-scale trade and services. Moreover, tax evasion by large segments of the formal economy is particularly widespread in the trade sector and among self-employed professionals and property owners, and tax exemptions are still common. Thus, if the tax net captures only half of the economic activity (not an unreasonable estimate), a 20 percent tax ratio translates into a 40 percent ratio on the average for those who pay taxes.

The widespread effort to reform the tax structure by reducing the tax rates and abolishing tax exemptions is generally intended to be revenue neutral, if fully implemented. Low import duties and excise rates on a broad base of goods rather than high rates on a narrow base will most likely also reduce the incentives to smuggle, given the substantial fixed costs associated with smuggling. However, while reducing rates usually meet few obstacles, the removal of exemptions has at times been delayed or only partially executed, due to resistance by vested interests, leading to unanticipated shortfalls in revenues.

The Government should also consider innovative ways of widening the tax base by taxing the informal sector. Several studies clearly indicate that the informal sector has expanded during the last few years (URT, 1991b; and Bagachwa and Naho, 1993 and 1995). This expansion is partly caused by the deregulation and liberalisation of the economic system in Tanzania, partly due to increased competition which has given firms incentives to attempt to reduce costs by evading labour and tax regulations. The increase in petty trading during the last decade is partly explained by the fact that local businessmen transfer their trade from the shops to the streets, thereby avoiding taxes. As a result, the tax base are further undermined.

Experiences from other Sub-Saharan countries indicate three possible ways of responding to this situation (IMF, 1992):

- By imposing a low (e.g., 2-3 percent) presumptive tax on all imports which can be credited against income taxes for the registered taxpayers. In this way an effective tax is imposed on the importers belonging to the informal sector, and an incentive for registered taxpayers to file a tax return is created (e.g., implemented in Mauritania, Niger, and Togo).
- By imposing low excises on mass consumption commodities, thereby taxing the informal sector indirectly on its consumption basket (e.g., implemented in Senegal and Mauritania).
- By raising minimum business licence fees (e.g., implemented in Niger).

Efforts to reduce tax evasion should continue. This can be done by higher penalties and better administration. Penalties can generally be increased without any pecuniary costs to the government (Gordon, 1990). Better administration, on the other hand, normally requires additional spending both on salaries, equipment and facilities. Therefore, such considerations may make it tempting to fight against evasion with higher penalties rather than with better administration.

There are, however, several problems with this approach. First, when penalties are too high, often they are not applied. Second, even if the pecuniary costs to the government may be low or zero, there are other costs (political and social) associated with high penalties that cannot be ignored. Thus, the best policy is one that accompanies reasonable penalties with better administration through improvement of assessment and collection procedures, registration of taxpayers, use of computers, better audits, etc..

One factor that has tended to reduce revenue from customs duties and created profound distortions in the resource allocation mechanism of the market system, is the tax exemption on transactions associated with foreign development assistance. In addition to exemptions granted the donor agencies, these exemptions often include foreign companies engaged by the donors (e.g. construction companies). This has contributed in eroding the tax base not only for import

duties, but also for company and personal income taxes and taxes on domestic transactions. Tax exemptions on donor funded imports have similar distortionary effects as the tax-free status of government imports which has provided an incentive to leak into the domestic market construction materials and capital equipment, which exceeded project requirements. The import and capital intensive technologies characterizing many donor funded projects are indications of the distortions created by the tax free status. Anecdotal evidence also indicates that foreign companies have ousted local companies through this kind of unfair competition.

The Government should therefore consider imposing tax on imports of goods to bilateral and multilateral funded projects. At least two African countries (Senegal and Togo) have taken steps to eliminate tax exemptions related to bilateral and multilateral assistance by fully taxing capital imports financed from abroad and crediting donor accounts for the taxes paid (IMF, 1992). While these procedures do not directly add any revenue to the budget, it introduces a system of controls that may reduce fraud, and thereby contribute to raise government revenues in the sector. It may further improve both budgetary transparency and resource allocation by fully accounting for public investment costs. It may also contribute to a more fair competition between local and foreign companies competing for donor contracts.

The tax administration that exist in Tanzania today will most likely be inadequate to cope with the reform proposals outlined above. The Government should therefore consider increasing expenditures on improving tax administration, even in the face of overall tight budget situations. The statutory changes should be as simple as possible. The more complex these changes are, and the more objectives the policymakers try to promote through the tax system, the more likely it will be that the tax administration will prove to be inadequate to cope with them (Tanzi, 1991). This is an area where so far progress has been very slow, but it is the area which will largely determine whether the transformation of the Tanzanian tax system will be successful.

Revenue projections implicit in the Rolling Plan and Forward Budget (RPF) seem, in general, to be unrealistically high, in which case other variables must be adjusted, and rendered consistent with a feasible revenue budget. The experiences from fiscal year 1992/93 show that caution needs to be exercised in setting tax revenue targets, and that substantial increases in tax revenue generally take time. In the tax reform process at least one clear tendency therefore needs to be addressed:

The tendency to be overly optimistic in setting targets on the likely revenue impact from changes in tax policy and tax administration.

A general lesson from tax reforms is that reformers should as a rule be *risk averse* (Bird, 1983 and 1992). This suggests the importance of fiscal diversification. It further implies that the recommended changes should be considered carefully to ensure that their full introduction will not damage revenue yields severely or produce unexpected (and undesirable) distortions and inequities. This counsel of caution means that considerable thought and effort have to be devoted to institutionalizing and implementing even the most desirable reforms before serious - and in the worst cases, irreversible - mistakes are made. An essential element in a meaningful tax reform is thus a careful, detailed, and realistic study of the limits and potentials of the institutional and administrative system that is expected to implement and enforce the tax reforms.

The points made above may sound obvious, but only too frequently there is limited consistency in the overall plan in many developing countries (Musgrave, 1987). One reason is that the Ministry of Finance typically deals with tax policy and current expenditures, whereas capital expenditures (investments) and general planning are part of the planning ministry (or National Planning Commission). Tanzania is no exception in this respect. With inadequate communication between the two ministries, it is problematic to ensure consistency of individual tax changes with the overall objectives of tax reform (Bird, 1992; and Fjeldstad, 1995a).

The discussion in this paper reinforces the arguments with respect to the importance of improving the quantitative analysis of revenue policy, and taking more specific and focused measures to improve tax administration. These problems also reinforce the need for a rigorous quantitative analysis of revenue policy measures, to be used as the basis for developing more realistic revenue projections.

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