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B4 PUBLIC FINANCE AND TAXATION

PUBLIC FINANCE AND TAXATION

STUDY TEXT

B4

Intermediate level

THE NATIONAL BOARD OF
ACCOUNTANTS AND AUDITORS
TANZANIA (NBAA)

B4

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STUDY TEXT

NBAA

NATIONAL BOARD OF ACCOUNTANTS AND AUDITORS

MSEMA KWELI

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FOREWORD.

The National Board of Accountants and Auditors is a professional body in Tanzania, established under the Auditors and Accountancy Registration Act No 33 of 1972 (CAP 286 R.E.2002). The Board has been charged with among other things, the responsibility to promote, develop and regulate the accountancy profession in the country.

In fulfilling its statutory obligations, NBAA prepares National Accountancy Examination Scheme for students aspiring to sit for Accounting Technician and Professional Examinations. Further, for effective implementation of the examination scheme and improve examination results, the Board provides Study Guides for all subjects to assist both examination candidates and trainers in the course of learning and teaching.

The Study Guides have been prepared in the form of text books with examples and questions to enable the user to have comprehensive understanding of the topics. The Study Guides cover a wide range of topics in the NBAA syllabi and adequately cover the most comprehensive and complete knowledge base that is required by a leaner to pass the respective examination levels.

Furthermore, the Study Guides have been prepared to match with the Competency Based Syllabi to enable the learners to be exposed to practical understanding of issues rather than memorisation of concepts. In this case, the Study Guides are characterized by the following features:-

1. Focus on outcomes – The outcomes shown in every topic provides clear understanding on what to be learnt.

2. Greater workplace relevance – the guides emphasize on the importance of applying knowledge and skills necessary for effectively performance in a work place. This is different from the traditional training where much concern has been expressed in theoretical perspectives.

3. Assessments as judgments of competence – The assessment questions embedded in the Study Guides are adequate measures of understanding of the subject matter.

Study Guides are also useful to trainers specifically those who are teaching in the review classes preparing learners to sit for the professional examinations. They will make use of these Study Guides together with their additional learning materials from other sources in ensuring that the learners are getting sufficient knowledge and skills not only to enable them pass examinations but also make them competent enough to perform effectively in their respectively workplace.

NBAA believes that these standard Study Guides are about assisting candidates to acquire necessary skills and knowledge that will enable them to perform as professionals. The outcomes to be achieved are clearly stated so that learners may know exactly the skills and knowledge they are supposed to acquire in a particular topic.

NBAA wishes all the best to NBAA Examination candidates, trainers in their review classes, lecturers in the higher learning institutions and all other beneficiaries of these learning materials in making good use of the Study Guides towards promoting the accountancy profession in Tanzania.

CPA. Pius A. Maneno
EXECUTIVE DIRECTOR
JUNE, 2019

STUDY CONTENTS

B4 – Public Finance and Taxation

Features of the book

‘The book covers the entire syllabus split into various chapters (referred to as Study Guides in the book). Each chapter discusses the various Learning Outcomes as mentioned in the syllabus.

Contents of each Study Guide

‘Get Through Intro’: explains **why** the particular Study Guide is important through real life examples.

‘Learning Outcomes’: on completion of a Study Guide, students will be able to understand all the learning outcomes which are listed under this icon in the Study Guide.

The Learning Outcomes include:

‘Definition’: explains the meaning of important terminologies discussed in the learning Outcome.

‘Example’: makes easy complex concepts.

‘Tip’: helps to understand how to deal with complicated portions.

‘Important’: highlights important concepts, formats, Acts, sections, standards, etc.

‘Summary’: highlights the key points of the Learning Outcomes.

‘Diagram’: facilitates memory retention.

‘Test yourself’: contains questions on the Learning Outcome. It enables students to check whether they have assimilated a particular Learning Outcome.

Self-Examination Questions’: exam standard questions relating to the learning outcomes given at the end of each Study Guide.

EXAMINATION STRUCTURE

The syllabus is assessed by a three hour paper based examination. The examination will consist of two sections

Section A	One compulsory question (covering a range of syllabus content)	40 marks
Section B	Three questions out of Five	60 marks

SECTION A

PUBLIC FINANCE AND NATIONAL INCOME

A1

STUDY GUIDE A1: INTRUCTION TO PUBLIC FINANCE

Get Through Intro

Public finance plays a vital role in deciding the fate of development of a country. How a government raises funds, how those funds are spent and the effect of these activities on the economy and society has, therefore, been a subject of continuing interest to thinkers since ancient times.

Government needs funds to perform various functions to achieve economic and social objectives. These funds are referred to as public revenue. The government receives revenue from various sources like taxes, fees, grants etc; tax revenue is the major source of revenue for any government.

One important aspect that first needs to be understood is why the Government needs to intervene in the running of the economy. The emergence of public finance as a central discipline in economics has its origin in the recognition of the fact that all the needs of the public cannot be met by the private market. There is a risk that the public goods and services will not be provided at all, or may be provided inadequately if left entirely to the private market. These are goods and services that can be provided only by the government. A simple example could be national defence.

This Study Guide explains the meaning of public finance, explain the economic functions of public finance and explains the rationale behind the need for intervention of the government in the economy.

Learning Outcomes

a) Explain the meaning of public finance and describes the differences between public finance and private finance.
b) Discuss the rationale for government intervention in the economy.
c) Discuss the economic functions of the government (allocation function, distribution function and stabilization function)
d) Describe the importance of public finance

1. Explain the meaning of public finance and describes the differences between public finance and private finance

[Learning Outcome (a)]

1.1 The meaning of public finance

Public finance is the study of the financial activities of governments and public authorities. It describes and analyzes the expenditures of government and the techniques used by governments to finance its expenditures. It deals with the economic role of government as a response to market failures, its limitation in responding to such failures, the design and evaluation of expenditure and tax program, and short & long term consequences of the deficit in the economy.

i) Public finance as a science

Public finance is concerned with the study of how the government collects revenue, how the expenditure is financed and how this procedure is monitored. It includes the study of the principles applied while raising revenue, and spending of that revenue by the Government. Thus, the various principles which form the basis of the collection of revenue by the government, maintenance of that revenue and outlay of the expenditure forms the subject matter of public finance. Public Finance is considered a science because it requires the application of scientific methods of investigation. It, however, depends upon two others other sciences - Political Economy and Political Science. While on the one hand, it draws largely upon the conclusions of these two sciences for its premise, yet on the other, it contributes a lot to them. However, the scope of the science of public finance now-a-days is not just limited to the functions of raising revenue by imposing taxes for covering the cost of administration and defense. It has widened considerably due to the fact that modern states have to perform manifold functions to promote the welfare of its citizens. In addition to maintaining law and order within the country and provision of security from external aggression, it has to perform many economic and commercial functions. Due to the increased activities of the state, there has taken place a vast increase in the expenditure of the public authorities. The sources of revenue have also increased. Taxes are levied not for raising the revenue alone but are used as an important instrument of economic policy. Public finance now includes the study of financial administration and control as well.

ii) Public finance as a branch of economics

Public finance encompasses many theories that have been expounded relating to the efficient collection, maintenance and expenditure of government funds. Therefore, it has now developed as a branch of economics, as it deals with the income and expenditure of funds of the government, including financial administration and control.

iii) Public finance as a process

Public finance can also be regarded as a process in view of the following:

- It studies and documents the steps followed by the public authorities in order to resolve financial problems.
- It is concerned with in the operational issues regarding the laws relating to finance in the economy/country.
- It shows the methods of income collection (by way of various types of taxes etc.), the amount of funds collected, and also how these sources of funds are classified.
- It reflects how the funds are branched out to various channels.

iv) Public finance as an art

Public finance is also sometimes regarded as an art because it involves finding the best ways of adopting the laws and policies to better conform to the intended objectives. It also suggests ways in which government personnel can try to adopt an economical approach with regard to public funds.

1.2 Public finance versus private finance

In order to understand public finance better, we need to understand how it is different from private finance.

Public finance and private finance are based on the same fundamental principles and share certain similarities, such as aiming for optimum use of limited resources, requiring efficient administration etc. However, they are also different in many respects. Some of the differences are discussed below:

Public	Private
M	
Public finance evaluates the role of the government in the areas of income and expenditure (including administration and control) of public authorities with a view to benefiting the public.	Private finance refers to the monetary resources of an individual economic unit. It includes the income and expenditure as well as the debt of individuals and business entities.
O	
The aim of public finance is to benefit the public; and is utilised for the society as a whole.	The aim of private finance is to bring about benefits to individual economic units like individuals, entities etc.
Nature of	
The government, which administers public finance, is a perennial body. Hence, it invests in funds that have long term gestation periods (like development of iron industry) which would bring about future economic	On the other hand, private finance is held by individuals and who aim to make short term profits. Therefore, they invest their money majorly on short term investments.
Sources of	
The government has innumerable sources of income like levy of taxes, printing currencies, raising loans internally as well as externally from bodies like world bank etc. The government can also call upon the resources of the society	The sources of finance for private entities are limited in comparison. The extent of availability of finance depends upon the ability of an individual / entity to raise money. Moreover, credit limit or loans are sanctioned based on
Obligatory / elective	
It is compulsory for individuals to contribute to the government in the form of taxes, other levies etc. Moreover, the government can, if necessary, compel citizens to contribute, even by force.	A private entity / individual cannot compel others to extend finance to the entity/individual.

Benefi	
The revenue collected by the government goes back to its citizens in one form or the other. However, the person who paid the taxes may not be the one who receives the benefits. In other words, the provider of	In the case of private finance, the person/entity that provides the finance usually gets the benefits.
S	
Details of public finance, such as the contributors, the amount of contributions, the income and the expenditure, are made public.	In the case of private finance, these details can be withheld from the general public; to some extent, the individuals and entities have a right to secrecy regarding their sources of finance, incomes and expenditures.

2. Discuss the rationale for government intervention in the economy.

[Learning Outcome (b)]

2.0 Rationale for Government Intervention in The Economy.

The idea of government, although then not recognised as government, had been instituted among humans even before the recorded history. Initially, the societies that were a very small group of individuals would manage themselves with relatively little government. But when the societies started becoming large, complex and technologically sophisticated, the need arose for a referee, a rule setter and authority for settling disputes.

The government plays a key role in solving problems in the country. To achieve this, the government needs to expand its activities through the expansion of the public sector. But the important issue that first needs to be understood is why does an economy require a public sector at all; why is it not possible for the private sector i.e. the market to take care of all that the people in the country need for their living and well-being?

The answer to this can be found in the fact that the economic activity of the private sector can never fulfil all the requirements of a society. Some goods (known as public goods) have certain inherent characteristics due to which it becomes impossible for the private sector to provide these goods to the society; for instance, the national defence function cannot be undertaken by the private sector.
Certain other public goods can actually be provided by the private sector, but often, the supply of such goods falls short of the demand. The main reason for this is that the efficient functioning of the market system requires certain characteristics such as perfect competition in the entire market, perfect knowledge of the market, perfect mobility etc. These conditions are hardly ever fulfilled in a market economy. As a result, public goods are underprovided by the market.

There are two economic rationales for government intervention in the economy: social efficiency and equity. Social efficiency is achieved at the point where the marginal benefits to society for either production or consumption are equal to the marginal costs of either production or consumption. Issues of equity are difficult to judge due to the subjective assessment of what is, and what is not, a fair distribution of resources.

Some of the main reasons for market failure are:

- the existence of monopoly in many areas,
- the failure of the price to reflect the opportunity cost,
- the presence of spill overs, decreasing costs, immobility; and imperfect knowledge.

The failure of the market system calls for government action. The need for government activity arises due to the following reasons:

To ensure the production of goods and services that could not be supplied by the private sector. In a free market there may be inadequate provision for dependants and an inadequate output of merit goods. Also the activities involving risks and long gestation period are not the preferred choice of the private sector. Government intervention ensures the smooth supply of the public goods and supply in adequate quantity.

To avoid failure of the market mechanism in safe guarding the interest of consumers. Markets may respond lethargically to fluctuations in demand and supply which may lead to an imbalance and instability in the economy.

3.0 Discuss the Economic Functions of the Government (Allocation function, Distribution function and stabilization function). [Learning Outcome b]

3.0 The Economic Functions of the Government (Allocation Function, Distribution Function and Stabilization Function).

There are various functions of governments in market economies identified by various economists. These functions mainly include providing the legal and social framework, maintaining competition in the market, providing public goods and services, redistributing income, correcting the externalities and stabilizing the economy.

Richard Musgrave has divided the economic role of government into three major functions:

(i) Allocation function
(ii) Distribution function
(iii) Stabilization function

3.1 Allocation function

Allocation function deals with the determination of the appropriate process to divide the total resources of the community between private goods and social goods. Government has to provide for public goods and services, such as national defense, primary education, public transport, health care, government administration etc. Private goods are available to only those who can buy them. Therefore these are limited to some individuals of the community. On the other hand, public goods must be available to all, even to those who can't afford them financially. Thus, the public goods are essential for consumers but cannot be provided through market mechanism and therefore government has to provide them. This makes it vital for the government to allocate its resources to ensure the essential public goods and services can be provided to the people of the country.

The function of determining the funds allocation is closely related to the issues of taxation and spending. The allocation of funds depends upon the revenue collected by the government in the form of taxes and duties and then using that revenue for the specified purposes.

The national budget of the country determines the various overheads for which the funds are to be allocated. The budget specifies the amount of funds set aside for the purposes specifically laid out by the government. Thus, proper allocation of sufficient funds for appropriate purposes has a direct impact on the economic development of the country.

3.2 Distribution function

Distribution function with reference to public finance refers to activities and policies of the government that affect the distribution of income and wealth. Distribution simply means the sharing of national income by individuals in a society. Everything that the government does, such as framing policies to provide primary education or to make available subsidised food to underprivileged sections of the society etc., affects the distribution of income and wealth to various sections of the society. The market forces cannot be relied upon to create an equal society; therefore a budgetary process is required. Under the allocation function, the fiscal policies set out the various overheads and also set aside funds for each of the overhead. The distribution function then determines more specifically how those funds will be distributed through various sections of the economy.

3.3 Stabilisation function

Stable economic growth is the key objective of the budgeting process. The stabilisation function is another important function of the economic policy to achieve the objective of stable economic growth. Stabilisation refers to those government actions that influence the overall level of employment, output and prices. The stabilization function attempts to maintain a reasonable degree of price stability. The economic instabilities, whether under conditions of inflation or depression, affect the economy of a country. Every change in the economy will have the effect of benefiting someone in the community and harming others. In such a situation, the appropriate policy measures applied by the government to avoid the situations of infla- tion and unemployment help in levelling the aggregate demand in the economy of the country. Such measures are called stabilisation measures. It is also important to note that the economic measures are not the only means of achieving economic stabilisation; the monetary policy, debt policy and income policy also need to be considered. Monetary and economic policies often complement each other. The economic growth of the country could become unstable unless appropriate restrictions are put on spending which ultimately may result in periods of unrestrained growth and contraction. While many economists criticise the policy of the government to put restraint, the stock market crash of 1929 made it clear that unregulated growth could have serious consequences. The market is cyclical in nature i.e. when growth periods end they are followed by contraction in the form of recessions. Thus, it is evident that unrestrained growth of the market cannot continue for an indefinite period. Therefore, it is imperative that the economic policies are designed to anticipate and mitigate the effects of such economic trench.

4.0 Describe the importance of public finance.

[Learning Outcome (c)]

4.0 The Importance of Public Finance

(i) Ensuring economic and financial stability

Public finance is used to ensure economic and financial stability in an economy. Economic stability is the absence of excessive fluctuations in the economy, whereas financial stability can be achieved by efficient allocation of resources by appropriate policy making. For example, an increase in direct taxes will reduce the money available with the people to purchase goods and services and will, in turn, help to reduce inflation. On the other hand, increase in public expenditure during depression helps to increase demand for goods and services, which is otherwise very low during periods of depression.

(ii) Optimum utilisation of resources

Public finance ensures optimum utilisation of scarce resources by adopting suitable monetary policies.

(iii) Effective tool to tackle unemployment

Public finance is an effective tool to tackle unemployment - for example, the government sets up fiscal policies which increase employment opportunities.

(iv) Capital formation

Public finance involves providing infrastructure like railways, road-ways, improved transportation etc. This kind of capital expenditure, in turn ensures increase in capital formation, which brings about long-term benefits to the public in general.

(v) Improved income and services of economy

Public finance involves raising funds from the public. Furthermore, investments in such funds is sometimes linked to a reduction in the amount of tax paid by the general public. This helps in increasing the income and savings of an economy, thereby helping in its development.

Self-Examination Questions

Question 1

Free riders are actors who take more than their fair share of the benefits or do not shoulder their fair share of the costs of their use of resource, involvement in a project, etc. The free rider problem is the question of how to prevent free riding from taking place, or at least limit its effects.

Required:

(a) Explain any six [6] solutions to the free rider problem.
(b) Define a public good and explain two main properties of such a good.

Question 2

In the presence of externalities, an inefficient allocation of resources can emerge if nothing is done about it. Therefore, private individuals acting on their own and the government may intervene to make sure there is efficient allocation of resources.

Required:

Explain any five specific measures to be taken by private individuals and the government to reduce the effect of externalities.

Question 3

Over time, the mix between public and private modes of provision of public goods has changed substantially. There is much greater private responsibility for education, health, related security services and other related services than in the past. No one can predict with greater accuracy what will happen in the future but the right mix of public and private provision of goods should be a topical issue in the near future.

Required:

Briefly describe any FOUR considerations which should be taken into account in finding the right mix of public and private provision of goods.

Question 4

The market often fails, but the government often does not succeed in correcting the failures of the market. The recognition of the limitation of the government implies that the government should direct its focus only to those areas in which the market failures are most significant and where there is evidence that the government intervention can make a significant difference.

Required:

Describe different schools of thought and perspectives on the role of the government in the economy.

Question 5

(a) Identify any four (4) characteristics which differentiate public goods from private goods.
(b) ‘A perfectly competitive economy is capable of functioning satisfactorily without formal government intervention and so without taxation. This is, however, far apart from the world of reality’
Required:

(i) In view of this statement, discuss the economic role of the government in supplying public goods to the economy.
(ii) Identify possible positive and negative implications of recommended government intervention to the market system.

Question 6

Public finance plays a vital role in deciding the fate of development of a country. How a government raises funds, how those funds are spent and the effect of these activities in the economy and society has been a subject of continuing interest to thinkers since ancient times.

Required:

Discuss the rationale for government intervention in the economy.

Question 7

(a) Describe the meaning of a "public good".

(b) The concept of "public goods" is confusing because it confounds three analytically distinct concepts: excludability, rivalry and public finance.

Required:

Explain why public goods are regarded as pedagogical bad.

Question 8

Government provides public goods and merit goods because some of these goods have characteristics which make them less suitable for market provision.

Required:

Explain briefly the concepts of "public goods" and "merit goods", and describe at least two characteristics which make government intervention in their provision inevitable.

Question 9

(a) Explain the functions of a government relating to public finance, in a developing economy.

(b) Public finance can be viewed in different perspectives depending on the role of the government in the area of income and expenditure (including administration and control) of public authorities with a view to benefiting the public.

Required:

Briefly discuss the perspective of public finance as science and as a process in the area of income and expenditure.

Question 10

(a) Juma has been wondering why governments interfere in an economy causing in many cases market distortion. Since his academic background is medicine, he has approached you to advise him on that.

Required:

Discuss why government can be compelled to interfere in a successful free market economy.

(b) Externalities are those gains and losses sustained by others as a result of actions initiated by producers or consumers or both, and for which no compensation is paid. Externalities are sometimes called "third part effects", "neighborhood effects" or Spillovers". As an example of an externality, consider a chemical firm which discharges noxious wastes into a river estuary, killing all the fishes and resulting in endangering the livelihood of the fisherman: nothing is paid for this loss.

Required:

Discuss at least four approaches that local or national governments can use in an attempt to control pollution (negative externalities) and its effects.

Question 11

(a) Public goods and services are generally provided by the government with a view of satisfying public needs. Sometimes a government may provide goods at a price while an individual or firm may provide goods for free.

Required:

Comment on whether:

(i) A bridge constructed by the government, whereby bridge toll is charged, amounts to a public good.

(ii) A bore hole dug by a private firm, whereby anybody can fetch water for free, amounts to a private good.

(b) Not all goods may be purely public goods. Some goods have characteristics of both private and public goods.

Required:
Briefly discuss, with the help of examples, when will education and national park fail to meet the criteria of pure public goods.

Question 12
Both allocation and distribution fiscal functions of public sector are designed to shift resources from one point to another in order to achieve fairness and equity within the society.
Required:
Distinguish between the two fiscal functions.

Question 13
(a) Describe at least four roles of public finance in a country's economy.
(b) Explain at least four primary functions of a government relating to the public finance.

Question 14
Often missing from the discussion and current thinking on the role and nature of government intervention in the economy is the negative implications associated with the government intervention.
Required:
Evaluate the likely harmful effects that government intervention is likely to create.

Answer to Self-Examination Questions

Answer to SEQ 1
(a) Possible solution to free rider problem
(i) ***Dominant Assurance Contracts.*** Assurance contracts are contracts in which participants make a binding pledge to contribute to a contract for building a public goods, contingent on a quorum of a predetermined size being reached. Otherwise their money is refunded. A dominant assurance contract is a variation in which an entrepreneur creates the contract and refunds the initial pledge plus an additional sum of money if the quorum is not reached.
(ii) ***Coasian Solution.*** The coasian solution, named for the economist Ronald Coase and unrelated to the Coase theorem, proposes a mechanism by which potential beneficiaries of a public good band together and pool their resources based on their willingness to pay to create the public good. Coase argued that if the transaction costs between potential beneficiaries of a public good are sufficiently low, and it is therefore easy for beneficiaries to find each other and pool their money based on the public good's value to them, then an adequate level of public goods production can occur even under competitive free market conditions. In some ways, the formation of government and government-like communities such as homeowners associations can be thought of as applied instances of practicing the coasian solution by creating institutions to reduce transaction costs.

(iii) ***Government Provision.*** If voluntary provision of public goods will not work, then the obvious solution is making their provision involuntary. One general solution to the problem is for government or state to impose taxation to fund the production of public goods. The difficulty is to determine how much funding should be allocated to different public goods, and how the costs should be split. Ideally, these decisions should be made democratically following advice informed by economic theory.

(iv) ***Subsidies.*** A government may subsidize production of a public good in the private sector. Unlike government provision, subsidies may result in some form of competitive market. The potential for cronyism can be limited with secret bidding for the subsidies or application of the subsidies following clear general principles.

(v) ***Incomplete Markets.*** Pure public goods and services are not the only goods and services that private markets fail to provide adequately. Whenever private markets fail to provide goods or service even though the cost of providing it is less than what individuals are willing to pay, there is a market failure that we refer to as Incomplete Markets (because a complete market would provide all goods and services for which the cost of provision is less than what individuals are willing to pay).

(vi) ***Imperfect Competition.*** For market to result in Pareto efficiency, there must be perfect competition-that is, there must be sufficiently large number of firms that each believes it has no effect on prices. But in some Industries, there are relatively few firms, or one or two firms have a large share of the market. Output in imperfect competition is lower than competitive output hence welfare loss. Government can attempt to reduce or eliminate inefficiency resulting from market power by making it illegal for a firm or a group of firms to exercise or acquire market power.

(vii) ***Asymmetric Information.*** One of the most common information problems occur when participants in potential exchange are not equally well informed about the product or service that is offered for sale. Economists use the term asymmetric information to describe situations in which buyers and sellers are not equally informed about the characteristics of products or services. In these situations sellers are typically much better than buyers, but sometimes the reverse will be true.

(viii) ***Merit Goods.*** A merit good is defined in economics as a good that is under consumed if provided by the market mechanism because individuals typically consider how the good benefits them as individuals rather than the benefits that consumption generates for others in society. In economic terms, this is because the positive externalities of the good are not internalized by consumers. To increase efficiency, the state may choose to encourage greater production or consumption of a merit good through state provision, regulation, subsidies or to produce the good itself. Goods typically considered to be merit goods include education and preventive healthcare.

(b) A public good is a good that is hard or even impossible to produce for private profit, because the market fails to account for its large beneficial externalities. By definition, a commodity is called a public if its consumption by any one person does not reduce the amount available to others. Or a good is said to be a public if providing good to anyone makes it possible, without additional cost, to provide it to everyone. Public good possess two properties:

(i) **Non-rivalrous:** Its benefits fail to exhibit consumption scarcity; once it has been produced, everyone can benefit from it without diminishing other’s enjoyment. If this good is supplied to one person there are huge positive externalities to others.

(ii) **Non-excludable:** Once it has been created, it is very difficult to prevent access to the good by others. Defence is a good example of this. If defence forces exist to protect a country from external aggression, then it is impossible to exclude anybody in that country from being defended.

A free market is highly unlikely to produce the optimum amount of any public good. Such important goods like national defence will be under produced due to the free rider problem.

Answer to SEQ 2

Measures to reduce externalities:

Private Individuals Response

- ***Mergers.*** This is the process of internalizing it by combining the parties involved in generating the externality. This may result each part to be more responsible and take the corrective measure so that the total effects of the externality won't affect their welfare. However, sometimes it is very difficult to have a merger when the externality involved is the large scale where many parties are involved.
- ***Social conventions.*** This is when the certain social conventions attempts to force people to take into account the externalities they generate.

Government Response

- ***Taxes.*** This is when the government levy tax on the polluter that makes up for the fact that some of the inputs are priced too low. This is known as Pigouvian tax, named after British Economist A.C. Pigou in the 1930s. The tax is levied on each unit of polluter's output in an amount just equal to the marginal damage it inflicts at the efficient level of output.
  There are practical problems in implementing Pigouvian tax system, including determination of the correct tax rate to use. More generally the tax approach assumes it is known who is doing the polluting and in what quantities. In many cases, these questions are hard to answer.
- ***Subsidies.*** Given the fixed number of polluting firms, the efficient level of production can be obtained by paying the polluter not to pollute. Although this notion may at first seem peculiar, it works much like tax scheme. This is because a subsidy for not polluting is simply another method of raising the polluter's effective production cost.
- ***Creating a Market.*** The inefficiencies associated with externalities can be linked to the absence of a market for the relevance resource. This suggests another way for the government to enhance efficiency-sell producers permits to pollute. By doing so, the government in effect create market for clean air or water that otherwise would not have emerged.
- ***Establish Property Rights.*** Under certain circumstances, it may make sense for the government to create conditions that allow a market to come into existence but then stay out of the market.
- ***Regulation.*** Under regulation, each polluter is told to reduce pollution by a certain amount or else face legal sanctions. Regulation is likely to be inefficient when there is more than one firm.
- ***Evaluation.*** The presence of externalities often requires some kind of intervention to achieve efficiency. Implementing any environmental policy entails a host of difficult technical issues. No policy is likely to do a perfect job. However, most economist prefer market oriented solutions which are more likely to achieve efficient outcome than direct regulation.

Answer to SEQ 3

In finding the right mix of the public and private position, the following should be considered:

(i) **Relative wage and material cost:** If the public and private sectors pay different amounts for labor and material, then the less expensive sector is to be preferred on efficiency grounds. Input costs faced by public and private sectors may differ if public sector employees are unionized while their private sector counterparts are not.

(ii) **Administrative cost:** Under the public provision, any fixed administrative costs can be spread over a large group of people. Instead of everyone spending time negotiating an arrangement for garbage collection, the negotiation is done by one office for everybody. The larger the community, the greater the advantage to being able to spread these costs.

(iii) **Diversity of tastes:** Households with and without children have different view about the desirability of high – quality education.

(iv) **Distributional issues:** The community notions of fairness may require that some commodities be made available to everybody, an idea sometimes referred to as commodity egalitarianism.

Answer to SEQ 4

(i) **Different schools of thought**

- **Merchantilists' view** – Economic nationalism (favourable balance of trade). The government should actively promote trade and industry.
- **Doctrine of Laissez Faire** (Adam Smith, John Stuart etc. The government should leave the private sector alone, it should not try to regulate or control enterprises. But it should only ensure peace and order and erecting and maintaining public works.
- **Socialist View,** e.g. Karl Max, Robert Owen. They suggested the reorganization of the society to address grave inequalities in income and condition of the working class. They advocate the government to take a greater role for the state in controlling the means of production.
- **Market System 20th century** – the government implements market and private enterprises.

(ii) **Perspectives** – Administration role, protection role, social role, economic role, development role.

Answer to SEQ 5

(a) Characteristics of public goods (or social goods) vs private goods (market goods)

- **Product divisibility (non –exclusion)**

  Public/social goods are indivisible/are difficult to price in order to prevent some members of the society from its benefits. That is, the use of such goods does not reduce its availability to others.

- **Externalities**

  In contrast to private goods, pure public goods are characterized by the existence of externalities (also known as spillover effects, neighbourhood effects or third party effect), which represent economic effects which flow from their production or use to other parties of economic unit.

- **Marginal costs (non rival)**

  Public goods have zero or close to zero marginal cost, i.e. additional member of the society can be benefited without appreciably adding to its total cost.

- **Decreasing average cost**

  Pure public goods are characterized by decreasing costs due to economies of scale.

(b) Economic role of the government in supplying public goods

(i) The economic role of the government in supplying public goods to the economy Government intervention/interaction is inevitable, and so, necessary on the following grounds/arguments:

- Market tend to operate inefficiently (market failures) due to

Market mechanism can supply only a priced good

- Government intervention necessary to address free rider problem

  o Free market may give rise to monopolies

  o Free market may give rise to wasteful competition

- Market may fail to accelerate desired rate of growth
- Market economy is prone to trade cycles/successive periods of inflation and unemployment
- Locational planning problem

- Infrastructure

  Infrastructure or social overheads are commercially non-viable and require huge resources beyond the capacity of private sector

  -Provision of merit goods, such as education and health services can best be achieved by the government.

(ii) Positive and negative implications as a result of government intervention/role

Positive implications of government intervention

- According to traditional Keynesian Macroeconomics theories, many of the public expenditure/government spending, including recurrent expenditure can contribute positively to economic growth.
- High levels of government consumption are likely to increase employment, profitability and investment multiplier effects on aggregate demand
- Thus, government spending raises aggregate demand, leading to increased output depending on the size and effectiveness of expenditure multiplier.

Negative implications of government intervention

- When intervention is through taxation high taxes may serve as disincentive to invest, and work
- When intervention is through borrowing to finance growing government spending, borrowing may affect private investment since government accesses funds that could otherwise have been invested in the private sector, i.e. crowding out effect.
- May lead to a movement of resources in to more unproductive use.
- Continuous expansion of government moves expenditure in to less and less productive activities

Possibility of rent-seeking activities, i.e. people will tend to obtain income by having government transfers to themselves rather than providing goods and services to others.

Answer to SEQ 6

- To ensure the production of goods and services that could not be supplied by the private sector.
- To avoid failure of the market mechanism in safe guarding the interest of consumers.
- To establish the economy by controlling the ups and downs in the economy.
- To use the appropriate combination of taxes and subsidies as means of correcting market distortions.
- To set up regulatory bodies to monitor and control activities which are against the public interest.

Answer to SEQ 7

a) Public goods and services are produced by the government sector with a view to satisfying public needs. For example, national safety, public healthcare, clean air etc.

b) Public goods have two principle characteristics – non – exclusion and non – rival consumption. Each of the characteristics is explained below:

- **Non-exclusion**
  - Non-exclusion means that it is impossible to prevent people from using the goods/service or the cost of restricting the use of the goods to selected persons is exorbitant.
- **Non-rival consumption**
  - Non-rival consumption means that the use of goods by one individual does not reduce the quantum of goods available to others; or the same goods can be used simultaneously by a number of people.

(i) Non-rivalry creates the problem of public finance: how to pay for goods that, from a point of view of economic efficiency, should be provided at low cost or free of charge, because the marginal cost of an additional user is (close to) zero.

(ii) Non-excludability can be thought of as the problem of definition and enforcement of property rights: how to make agents take account of the effect their actions on others.

(iii) The public goods discussion violates the first basic pedagogical principle: explain one thing at a time. Confounding rivalry and excludability, it attempts to teach these two analytically, empirically and economically different concepts together.

(iv) The problem of public finance and the problem of the definition of property rights are confounded into one lecture, one chapter, what seems to be one idea. Moreover, to the extent that the pure public goods discussion ignores goods that are rival but non-excludable, or goods that are non-rival but excludable, the implications of rivalry or excludability are not fully discussed. Hence the second pedagogical principle, begin with basic concepts and work upwards, is violated.

(v) Finally, the concept of public goods is not grounded in reality. The concept of excludability, as defined in public goods textbooks, is based on technology that is whether or not it is technologically feasible to exclude those who do not pay from using the good. However, technological feasibility is a hypothetical construct.

Answer to SEQ 8

Concepts of Public goods and merit goods

Public goods are the goods which are provided by the government principally because of the jointness of their consumption, non-exclusion and non rivary. These include defence, law and order, street lighting, urban parking, urban cleaning etc.

The government must provide these since the exclusion principle cannot be applied, i.e. there is absolute jointness in consumption, and hence, no one can be separated from consuming the product.

Merit goods are goods which are provided by the state mainly because of ignorance and externalities. Also, merit goods are provided by government because are important and it provided by private sectors many people could not afford them. Such merit goods are education and health services. Characteristics of social goods and merit goods which make them less suitable for market provision.

Answer to SEQ 9

(a) Three key economic functions or roles of the government as stipulated by Richard Musgave are explained here under:

(i) **Allocation functions**

Allocation function deals with the determination of the appropriate process to divide the total resources of the community between private goods and social goods. Since private goods are available to only those who can buy them, the government has to provide for public goods and services, such as national defense, primary education, public transport, health care, government administration etc.

Considering the fact that, private goods are limited to some individuals of the community. Public goods must be available to all, even to those who can't afford them financially. Therefore the allocation of funds depends upon the revenue collected by the government in the form of taxes and duties and then using that revenue for the specified purposes.

(ii) **Distribution function**
Distribution function with reference to public finance refers to activities and policies of the government that affect the distribution of income and wealth. Distribution simply means the sharing of national income by individuals in a society. Everything that the government does, such as framing policies to provide primary education or to make available subsidized food to underprivileged sections of the society etc., affects the distribution of income and wealth to various sections of the society. The market forces cannot be relied upon to create an equal society; therefore, a budgetary process is required.

(iii) **Stabilization function**
Stabilization refers to those government actions that influence the overall level of employment, output and prices. The stabilization function attempts to maintain a reasonable degree of price stability. It is very important function of the economic policy to achieve the objective of stable economic growth. Even though many economists criticize the policy of the government to put restraint, the stock market crash of 1929 made it clear that unregulated growth could have serious consequences.

(b)

(i) **Public Finance is considered as science** because it requires the application of scientific methods of investigation. It is concerned with the study of how the government collect revenue, how the expenditure is financed and how this procedure is monitored. It includes the study of the principles applied while raising revenue, and spending of that revenue by the Government. However, depends upon two others other sciences – Political Economy and Political Science.

(ii) **Public finance is also regarded as a process** in the sense that it studies and documents the steps followed by the public authorities in order to resolve financial problems. It further concerned with in the operational issues regarding the laws relating to finance in the economy/country and it shows the methods of income collection (by way of various types of taxes etc.), the amount of funds collected, and also how these sources of funds are classified.

Answer to SEQ 10

(a) Why government interferes a successful free market

(i) The government tries to combat market inequities through regulation, taxation, and subsidies.

(ii) Government may also intervene in markets to promote general economic fairness.

(iii) Maximizing social welfare is one of the most common and best understood reasons for government intervention. Examples of this include breaking up monopolies and regulating negative externalities like pollution.

(iv) Governments may sometimes intervene in market to promote other goals, such as national unity and advancement.

(b) There are a number of approaches that local or national government can use in an attempt to control pollution and its effects. These include:

(i) **Pollution Taxes**

Tax will be levied to polluters for emitting certain quantities of pollution. The tax will compel polluting producers to include in the prices of their goods and this will increase costs of production and will in turn discourage production and therefore reduce the firm's or people; ability to emit pollution.

Advantage of pollution taxes:

Incentive to reduce pollution:

If a producer has to pay a tax based on the quantity of pollution created, then the producer can pay less as a result of emitting less pollution. Therefore, pollution tax can give a producer continuing incentive to reduce pollution.

(ii) **Direct Control**

Another approach to dealing with negative environment externalities is to introduce direct controls or legislation (often referred to as a command or control approach). This approach may specify minimum environmental standards, concerning air or water quality. Alternatively, direct controls may be imposed stipulating a complete ban on the use of particular inputs.

In some cases, the government requires installation of specific types of anti-pollution equipment such as catalytic converters for all new cars sold in the country.

(iii) **Trade-able Emission Allowances**

The use of emission allowances (or tradable permits) can be traded between producers whose economic activity results in pollution. With this system, the department controlling pollution will set a target for a reduction in a particular type of pollution. Generally, companies for the cost of pollution abatement is low can sell some of their allowances to other producers.

Advantage of tradable emission allowances:

Incentive for pollution reduction; As with pollution taxes, the introduction of tradable allowances can give firms an incentive to reduce actual levels of pollution. If a firm can find a way of reducing its emissions cheaply, it may find itself able to increase profits by selling some of its allowances to other firms.

(iv) **Social Conversion**

A number of social conversions can force people to take into account the environmental pollution. For example, school children can be taught that water pollution is irresponsibility. Another approach can be through seminars, educational discussion with members of the public, etc.

(v) **Subsidies**

Efficient level of production can be obtained by paying subsidies to polluters for not producing above certain limits.

Answer to SEQ 11

a) Public vs Private goods

i) A good being provided by the government does not necessarily make it a public good. A government may also supply private goods. Therefore, the focus shall be on the characteristics of goods rather than the provider

The bridge that charges tolls does not qualify to be recognized as a public good.

Public goods are provided free of charge and charging a price is a characteristic of a private good.

Also public goods have a characteristic of non-exclusion. That is, one may not be excluded from consuming the good.

In this case, those who have no ability to pay tolls will be excluded from consuming the good (crossing the bridge)

ii) The provider of good does not necessarily make a good private or public.

In this case the bore hole is not a private good since it has characteristics of a public good.

First, it is offered free of charge
Second, it has non-exclusion characteristic. That is, no person is rejected the right to consume the product. However, a person may choose not to consume the product – which makes it not a purely public good. But this would have been the same if the product was being offered by the government.
Third, the bore hole water may be consumed without rivalry. However, this is if it is assumed that the bore hole has plenty of water for every person in need.

Therefore, the bore hole is public good although it may not be as pure public good as national defense or road might be.

b) Pure public goods have three major characteristics:

1. Provided free of charge

2. Non-exclusion: no member of society may be excluded from consumption of the good either for reasons of prices or by his/her own choice

3. Non-rivalry consumption: when a member of society consumes the good, he/she does not deprive others from consumption of the good. This means also the good can be consumed simultaneously by all the members of society.

Now education and national park may lose the characteristics of pure public goods if they miss any of the above characteristics.

For example, when education institutions and national parks charge fees to get access to education/national parks they will no longer be pure public goods/services.

By charging prices also access to education/national parks becomes restricted to those who can afford the fees.

Also, where access to education is limited (even if it is free) and thus provided to some individuals who meet certain criteria, this means exclusion of some members from its consumption.

Similarly, it would be the case to national parks where there are certain requirements to be fulfilled by entrants (e.g. must use four-wheel drive motor vehicles). This excludes some members from national parks entry who cannot meet the requirements.

Answer to SEQ 12

- Allocation function shifts resources from the satisfaction of private wants to that of public wants
- Distribution function shifts resources from the disposal of one individual to that of another (between alternative private wants)

Answer to SEQ 13

(a) Roles of Public Finance in a country's economy.

(i) Ensuring economic and financial stability

Public Finance is used to ensure economic and financial stability in an economy. Economic stability is the absence of excessive fluctuations in the economy, whereas financial stability can be achieved by efficient allocation of resources by appropriate policy making for example any increase in direct taxes will reduce the money available with the people to purchase goods and services and will, in turn, help to reduce inflation. Public finance helps to reduce the economic imbalance on account of unequal distribution of income and wealth among the public.

(ii) Optimum utilization of resources:

Public finance ensures optimum utilization of scarce resources by adopting suitable monetary policies.

(iii) Effective tool to tackle unemployment:

Public finance is an effective tool to tackle unemployment for example the government sets up fiscal policies which increase employment opportunities.

(iv) Capital formation public finance involves:

Providing infrastructure like railways, roadways improved transportation etc. this kind of capital expenditure in turn ensures increase in capital formation which brings about long term benefits to the public in general.

(v) Improved income and service of economy:

Public finance involves raising funds from the public. Furthermore, investments in such funds is sometimes linked to a reduction in the amount of tax paid by the general public. This helps in increasing the income and savings of an economy thereby helping in its development.

(b) Primary functions of a government relating to the public finance

(i) Providing basic utility services and promoting social and economic development

The government is mainly engaged in providing public utility services like electricity, telephone, roads and high ways, transportation facilities etc. to the public such services are provided at economical rates so that these can be veiled by common man. The government generally establishes its own monopoly over the supply of such services, with a view to avoid consumer exploitation. In providing of such services the government invests in social and economic capital.

(ii) Encouraging capital formation

Industrialization is the key to development of an economy. This is brought about by investing in heavy infrastructure such as machinery and tools, chemicals, iron and steel. Such investments carry high risks and the return can be gained only in the long run. Therefore the private sector rarely makes investments. Thus it becomes the responsibility of the government to make such investments in these sectors which ultimately enables the economy to improve its capital formation.

(iii) Complementing private investment

The private sector also invests in industrial goods. However, whenever there is insufficient investment by the private sector, the government steps in and makes good the shortage. This ensures a balanced development of the economy with the government investing in less profitable sectors or back ward areas where private investment is not forthcoming.

(iv) Providing an environment conducive to development
The government encourages private investment in areas of economic development by setting up basic industries and providing financial assistance by promoting the development of banks.

(v) Conserving and efficiency utilizing natural resources
Economic development depends on the efficient and effective utilisation of its natural resources like oil, minerals aquatic life and forestry. Many economies especially the developed and developing economies are often faced with underutilization as well as inefficient utilization of its natural resources. The government therefore intervenes as well as conserve the natural resources.

Answer to SEQ 14

Likely harmful effects/negative implication the process of government intervention is likely to create

(i) Higher taxes or further borrowing required to finance growing government expenditure inhibit growth.
- High taxes serve as disincentives for households to invest, take risk and find jobs
- Borrowing on affect private investment since government accesses funds that could otherwise have been invested in the private sector, thus crowding out private investment.

(ii) Large government sector increases potential profits from rent-seeking activities.
- May lead to a movement of resources in to a more unproductive use.
- Rent-seeking occurs when people try to obtain income by having government transfers to themselves rather than providing goods and services to others.
- Engender corrupt practices where governance is weak.
- E.g. offering generous tax incentives to investment which would have come anyway. This is a loss to the government.

(iii) Continuous expansion of government move expenditure in to less and less productivities.

(iv) Continuous expansion eventually result in to government becoming too large and carries out activities which it is ill-suited.

SECTION A

PUBLIC FINANCE AND NATIONAL INCOME

A2

STUDY GUIDE A2: PUBLIC REVENUE

Get Through Intro

In case of a company, revenue is the income derived from sale of goods or services and in case of non- profit organisations, revenue is in the form of donations or membership fees etc. In other words, revenue is income received by an organisation. Revenue is very important for financial statement analysis. The performance of an organisation is measured in terms of net profit earned by the organisation (profit = net sales less expenses) as well as in terms of the top- line i.e. revenue earned by the company.

Government needs funds to perform various functions to achieve economic and social objectives. These funds are referred to as public revenue. Government receives revenue from various sources like taxes, fees, grants etc; tax revenue is the major source of revenue for any government. Revenue obtained by Government from sources other than tax is called Non- Tax revenue.

This Study Guide discusses the meaning and type of government revenue

Learning Outcomes

a) Explain the meaning and classification Public Revenue.
b) Describe sources of Government Revenue (Tax and Non-Tax Revenues)
c) Identify the factors distinguishing a tax from other sources of government revenue.
d) Explain the arguments for and against foreign aids

1.0 Explain the meaning and classify public revenue.

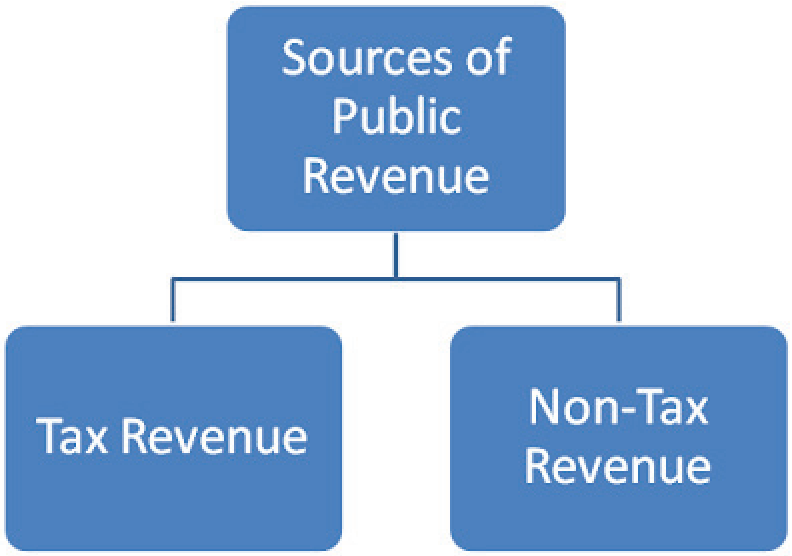
[Learning Outcome (a)]

1. **Meaning and Objectives of Public Revenue**

This refers to amounts received by the government from its various sources to meet expenditures. It includes all receipts of a public authority may secure during any period of time. Public revenue, consists of taxes, revenue from administrative activities like fines, fees, gifts & grants. Public revenue can be classified into two types.

(i) Tax revenue

(ii) Non tax revenue



2.0 Describe the sources of government revenue (Tax and nontax revenues)

[Learning Outcome (b)]

2. **Sources of government revenue (tax and non-tax revenues)**

2.1 Tax Revenue

Taxes are the first and foremost sources of public revenue. Taxes are compulsory payments to government without expecting direct benefit or return by the tax payer. Taxes collected by Government are used to provide common benefits to all mostly in form of public welfare services. Taxes do not guarantee any direct benefit for person who pays the tax. It is not based on direct quid pro quo principle.

Characteristics of Tax

The following are the characteristics of a tax :-

(a) A tax is a compulsory payment made to the government. People on whom a tax is imposed must pay the tax. Refusal to pay the tax is a punishable offence.

(b) There is no quid pro quo between a taxpayer and public authorities. This means that the tax payer cannot claim any specific benefit in return for the payment of a tax.
(c) Every tax involves some sacrifice on part of the tax payer.
(d) A tax is not levied as a fine or penalty for breaking law.

The governments collect tax revenue by way of direct & indirect taxes. Direct taxes includes; Corporate tax; personal income tax capital gain tax and wealth tax. Indirect tax includes custom duty, central excise duty, and VAT and service tax.

2.2 Non-Tax Revenue

The revenue obtained by the government from sources other then tax is called Non-Tax Revenue. The sources of non-tax revenue are :-

(i) Grants or aids

Grants can be defined as the non- repayable voluntary transfer of resources.
The grants could be of the following types:

- Grants provided by the central government to state government for specific objectives
- Grants provided by foreign countries to the Central/ State Governments (also called as foreign aid). Foreign aid may be given to support social causes, for contribution during emergencies/ natural calamities, for strengthening ties with the country or for commercial purposes.

(ii) Debts from other governments or banks/ funds

When public expenditure exceeds public revenue, governments resort to borrowings. Borrowings may be from:

- foreign countries or
- internal borrowings from the private sector in the form of debentures or bonds etc or
- internal borrowings from central bank of the country

(iii) Income from investments made by the Government

Governments invest excess funds in bonds, mutual funds of other institutions. The revenue that is earned by governments from such investments is in the form of interest or dividend.

(iv) Revenue from public enterprises

Government sets up public sector enterprises, which are owned and controlled by the government. The profit earned by such public sector enterprises is a source of revenue for the government. Furthermore when the public sector enterprise income from sale of its non-current asset, it is revenue for government, although it is a one- time revenue and is not a recurring income.

(v) Royalties

Royalty is received by the government when it allows private enterprises to use government/ public assets or intellectual property. Royalty is generally charged as a percentage of revenue derived from the use of the asset or a percentage of the unit price of the product sold. Example: Private sector enterprise has to pay royalty to the government to extract natural resources like petrol/ crude oil from government owned lands.

(vi) Fees and penalties

Government's charges fees for a number of services it renders to the general public. For example fees for issuing driving license/ passports, fees for generating copies of official documents, fines/ penalties levied for breaking traffic rules etc.

(vii) User fees

The government charges fees for use of its assets / services provided by the government. For example a toll is charged for the use of roads/ highways.

(viii) Subsidies received from other countries/ banks

Government receives subsidies from international banks/ monetary fund's which are an indirect source of revenue for the government.

(ix) Rent

Government may earn revenue by way of renting of owned buildings or by renting out parking space etc. A local authority like municipality may rent out some empty space to the central government on requirement.

3.0 Describe the factors distinguishing tax from other sources of government revenue.

[Learning Outcome c]

3. **Factors distinguishing a tax from other sources of government revenue.**
The unique factors which distinguish a tax from the other sources of government revenue are as follows:

(a) Taxes are mandatory charges; they are compulsory payment made to the government. People on whom a tax is imposed must pay the tax. Taxes are not voluntary contributions, donations or gifts to the state. Furthermore, refusal to pay the tax is a punishable offence.

(b) Only government or other taxing body has power to levy taxes, therefore other non government bodies like sports clubs, churches, political parties can not charge taxes.

(c) Depending on tax laws all person regardless of their citizenship pay taxes though non-citizens now get refunds of VAT paid in Tanzania for goods that will be spent outside of Tanzania. On the other hand, the non-government revenue are received from either individuals or corporates(depending on the type of revenue)

(d) A payment of tax, does not involve a "quid pro quo" status i.e. taxpayers cannot expect equal returns for the tax paid. On the other hand generally the non-tax government revenue like user fees has the characteristic of 'quid-pro-quo'.

(e) Though individuals and legal persons pay taxes to government, the government does not have an obligation to provide an individual account of how tax is utilized; in most cases; however governments account to parliaments of behalf of taxpayers.

(f) Taxes are usually paid and collected in monetary terms either coins or paper money
(g) Every tax involves some sacrifice on part of the tax payer.
(h) A tax is not levied as a fine or penalty for breaking law.

4.0 Explain the argument for and against foreign aids

[Learning Outcome d]

4. **The arguments for and against foreign aids**
A foreign aid is any form of assistance from a foreign country or foreign institutions.
Forms of Aids
   - Technical assistance
   - Capital (funds, machinery)
   - Grants
   - Gifts
   - Consultancy

Arguments for foreign aids

(i) Foreign aids supplement/increases domestic sources of finance, thus increasing the amount of investment and capital stock.
(ii) Foreign aids Finance development projects
(iii) Foreign aids promote good governance and democracy
(iv) A recipient country can obtain technology from a donor country.
(v) Aids are very useful during natural calamities such as floods
(vi) Aids promotes cordial relationships between a donor country and a recipient country

Arguments against foreign aids

(i) Aids create economic dependency
(ii) Some aids are not provided on time therefore cannot be utilized efficiently
(iii) Some aids are accompanied with some conditions which may be harmful to the economic and social interest of a country
(iv) Some aids are in poor quality and therefore useless.
(v) Aids may be a disincentive for domestic production.

Self-Examination Questions

Question 1

Examine the nature and types of non-tax government revenue.

Question 2

Discuss the non-taxation sources of government revenue in the country apart from Tax revenue.

Question 3

Explain three unique features of tax over the other sources of government revenue.

Question 4

Assume you are given the following information relating to the fiscal position of Tanzania for three years:

	% of GDP		
	2011/2012	**2012/2013**	**2013/2014**
Total Revenue	19.4	22.8	20.5
Domestic Revenue	14.4	15.9	15.9
Grants	5.0	6.9	4.6
Total Expenses	23.5	22.8	25.2
Deficit	4.1	0.0	4.7
Net Financing	5.9	1.7	0.3

Despite a considerable improvement on the fiscal performance between years 2011/2012 and 2012/2013 due to increase in domestic revenue, the government's main challenge is that almost one third of its revenue comes from external grants/foreign aid.

Required:

a) Discuss why foreign aid is important to a developing nation like Tanzania.
b) Outline the negative effects of foreign aid dependency.

Answers to Self-Examination Questions

Answer to SEQ 1

Nature and types of non-tax government revenue

a. **User Fees**

Fees are another important source of revenue for the government. A fee is charged by public authorities for rendering a service to the citizens. Examples are payment made by users if public services on government cost sharing in health and education. That is to say the payment made by users of public service i.e. health and education. Other examples include fees charged for issuing of passports, during licenses, etc. what makes user fees different from conventional taxes is that there is no compulsion involved in case of fees.

b. **Fines or Penalties**

Fines or penalties are imposed as a form of punishment for breach of law or non-fulfillment or certain conditions or for failure to observe some regulations. Like taxes, fines are compulsory payments without quid pro quo. The destination between taxes and penalties lies in the motive. A public authority imposes taxes mainly to obtain revenue and imposes penalties mainly as a form of punishment or to deter people from doing certain acts.

c. **Grants and Gifts**

Grants and gifts are voluntary contributions by individuals or institutions to the government. Gifts are significant source of revenue in the modern days. Grants from foreign countries are known as Foreign Aid. Developing countries receive military aid, food aid, technological aid, etc from developed countries. Unlike taxes, grants and gifts are voluntary.

d. **Surplus from Public Enterprises**

The Government also gets revenue by way of surplus from public enterprises. The Tanzania government has set up public sector enterprises to provide public goods and services. Some of the public sector enterprises do make a good amount of profits. The profits or dividends which the government gets can be utilized for public expenditure.

e. **Borrowing for Deficit Financing**

Deficit means an excess of public expenditure over public revenue. This excess may be met by borrowing from the market, borrowings from abroad, by the central bank creating currency. In case of borrowing there may be compulsion. The government may force various individuals, firms and institutions to lend to it at a much lower rate than the market would have offered. It is ordinarily presumed that money borrowed will eventually be repaid from funds raised from other sources of revenue, although in practice this may not always be the case.

Answer to SEQ 2

Revenues obtained by the government from sources other than tax are:

- Fees charged by government for rendering certain services. These are payment made by users of public services on government cost sharing in health and education, That is to say the payment made by user of public services i.e. health and education is not the actual cost that they were required to pay rather than contribution on cost already payable government.
- Grants and Gifts
- Fines and penalties are the payments made for the contravention of law.
- The Government also gets revenue by way of surplus from public enterprises.
- Borrowing of money.

Answer to SEQ 3

(a) Taxes are mandatory charges; they are compulsory payment made to the government. People on whom a tax is imposed must pay the tax. Taxes differ from contributions, donations or gifts to the state, which are voluntary. Furthermore refusal to pay the tax are a punishable offence.

(b) A tax is not levied as a fine or penalty for breaking law. On the other hand, fines or penalties are imposed as a form of punishment for breach of law or non-fulfilment or certain conditions or for failure to observe some regulations.

Though individuals and legal persons pay taxes to government, the government does not have an obligation to provide an individual account of how tax is utilised; in most cases; however governments account to parliaments of behalf of taxpayers.

Answer to SEQ 4

(a) (i) Helping the poor to save and invest in businesses through micro-finance programs which have created thousands of enterprises and employment.

(ii) Powerful in attracting private investments from individuals and businesses thus generating high tax revenues. This because aid improves water, transport, power, and education, which are powerful tools for attracting investment.

(iii) Increase national growth.

(iv) Aid is crucial for a long-term equitable and sustainable development, for improving gender equity, and for ensuring that poorest citizens can enjoy their rights. Real aid helps to transform lives.

(b) (i) Loss of policy autonomy for the government depending on foreign aid.

(ii) Aid can undermine accountability and responsiveness to national citizens, and delivery of services by the government; as government focuses on the relationship with the donors.

(iii) Aid can undermine the predictability of the government spending and therefore long-term planning.

SECTION A

PUBLIC FINANCE AND NATIONAL INCOME

A3

STUDY GUIDE A3: THEORETICAL CONCEPTS OF TAXATION

Get Through Intro

Tax is a financial charge imposed by the government. The fundamental purpose of taxation is to finance government expenditure. Any money the government expends mostly comes from taxation.

You will agree that having to pay tax from your earnings is a painful experience. You must also have wondered why the government needs to collect taxes. What is the purpose behind collecting a part of our hard-earned money? Most of the tax payers feel that paying taxes is a waste of their money.

This Study Guide explains the basic theoretical concepts of taxation starting from the nature and essence of taxation, explaining principles of taxation. Various approaches of classifying taxes will be discussed followed by a discussion on theories of tax distribution, effects of taxation and various taxation concepts. Lastly this Study Guide will explain the optimal taxation theory.

Learning Outcomes

a) Explain the nature and objectives/purposes of taxation
b) Explain the principles/canons of taxation
c) Identify and explain the bases on which taxes are classified
d) Explain principles of equity in taxation (benefits theory, sacrifices theory, ability to pay theory)
e) Describe the criteria for evaluating taxes
f) Discuss economic effects of taxation
g) Explain the incidence of taxation
h) Explain the concept of tax buoyancy and elasticity and taxable capacity
i) Explain the concept of excess burden and optimal taxation
j) Explain the relation between tax rate and revenue collection
k) Explain the concepts tax incentives and tax competition

Explain the nature and objectives/purposes of taxation, explain the principles/canons of taxation, Identify and explain the bases on which taxes are classified, explain principles of equity in taxation (benefits theory, sacrifices theory, ability to pay theory)

[Learning outcome a, b, c, and d]

1. The Nature and Objectives/Purposes of Taxation

1.1 Introduction

Taxation traces its origin to the ancient times as a major source of revenue needed for governance. Kingdoms, monarchies and even dynasties had an elaborate form of taxation imposed on their subjects to source funds that were used to run affairs of the government. Taxation has had a long and influential history in the shaping of civilizations throughout the world. All the great ancient civilizations – Egyptian, Romans , Greek, Persians, Zulu, Oyo, Malian, Songhai, Benin – taxed their people to achieve a collective greatness.

1.2 Definitions of Tax

Tax is one of the most important social and economic issue that has kept both the experts and the public preoccupied throughout the evolution of human civilization.

"Tax is a compulsory contribution to the state revenue, levied by the government on workers' income and business profits or added to the cost of some goods, services and transactions"

The Oxford Dictionary

"Tax is a compulsory a contribution imposed by a public authority regardless of the exact amount of service rendered to the taxpayer in return"

Dalton (1978)

"Tax is any leakage from the circular flow of income into the public sector, excepting loan payments and direct payments for publicly produced goods and services up to the costs of producing these goods and services." Charles M. Allan (1971)

According to Allan, this definition is clearly relevant to fiscal economics and is stated in terms of income flows. "Tax is unrequited, compulsory payments collected primarily by central governments."

The World Bank Definition

Tax is a source of derivative revenue; From the angle of the citizens, a tax is a coerced payment; From the administrative point of view, it is a demand for money by state in conformity to established rules; From the point of view of theory, a tax is a contribution from individuals for common expenditure."

Professor Adam Smith

These definitions shed light not only on the conditions under which people make a contribution to their government but also reflect a range of attitudes towards tax. In all definitions there is a pursuit to underpin whether taxation is a civic obligation, a bond between the rulers and the ruled based on reciprocity or just an unrequited payment to finance government expenditure.

Taxes are the **first and foremost sources of public revenue**. Taxes collected by Government are **used to provide common benefits to all** mostly in form of public welfare services. Taxes do not guarantee any direct benefit for person who pays the tax. The payment of tax is made by the members of the community without any assurance given by the tax-levying authority that they will get direct benefit in return for paying the tax. **There is no direct give and take relationship between a taxpayer and the tax-levying public authority.** It is worthy to note that;

- Tax is compulsory
- It is paid by the taxpayer for the benefit of all
- It is not levied in return for any special services

Tax is a financial charge imposed by the government. The fundamental purpose of taxation is to finance government expenditure. The imposition of taxation by governments withdraws money from the economy, and their expenditure returns the money to the economy.

Taxes are the most important source of public revenue and are necessary for the functioning of the government. Funds collected by way of tax are utilised by the government to provide various infrastructure/ facilities to the taxpayer; however benefits of such public expenditure by the government is enjoyed even by those people who are not liable to pay taxes.

Following are the essential features of any tax:

- It is generally payable in money
- It is a proportion or a percentage
- It is levied on persons
- It is levied by the government
- It is levied in order to cater to public purpose

1.1 Nature of taxation

Revenue from taxation may be in several forms:

The main taxes employed within Tanzania are as follows:

Tax	Suffered by
Revenue taxes	
Income tax	Individuals, Partnerships, Corporates
Import duty	Importer
VAT	Final consumer
Excise duty	Supplier
Capital taxes	
Capital gains tax	Individuals, Partnerships, Corporates
Property tax	Owner

Revenue Taxes

a) **Income tax**

It is a tax levied on the income of an individual. Income can be from any sources such as:

i] income from earnings (e.g. employment income / trade profit)
ii] income from pensions
iii] income from other benefits (e.g. rental income)
iv] income from savings (e.g. interest income)
v] income from investments (e.g. dividend income)

Income tax is calculated on earned income (i.e. income from employment)as well as on income from savings etc. Income from various sources is pooled together and tax is charged on the aggregate income after deducting the relevant allowance.

b) Import duty

Import duty is a tax collected on imports and some exports by the customs authorities of a country. It is usually based on the value or quantity of the goods that are imported/.

c) **VAT**
VAT is Value Added Tax. It is the tax which is paid on the value added. This tax is levied at each stage of production. VAT is a consumption tax paid by customers in addition to the price of the product.

d) Excise duty
Excise Duty is a duty charged on specific goods and services manufactured locally or imported on varying rates. It is mostly charged on alcohols, soft drinks, cigarettes, telecommunication services, money transfer services etc.

Capital taxes

a) **Capital Gains Tax**
When a person sells an asset that is in his / her possession, the profit arising from such sale is chargeable to tax as capital gains.
Therefore, capital gains tax liability arises when a 'chargeable person' makes a chargeable disposal of a chargeable asset. For example, Adam sells his business asset at a profit of Tshs 5,000,000. So, the amount of profit i.e. Tshs 5,000,000 is chargeable to capital gains tax.

b) Property tax
Property tax is levied at flat rates on the property value by the municipal or city councils. Applicable rates vary depending on the size, use and location of the property.

1.2 Purposes of taxation

(a) Economic purpose
Taxes have an economic significance; they are used to promote goals such as full employment, satisfactory rates of economic growth, and stability of the money supply. The economic goals of taxation are achieved by raising or lowering tax rates. The imposition of taxation by governments withdraws money from the economy, and their expenditure returns the money to the economy. Government therefore uses taxation policies to manage the economy by manoeuvring tax structure. For example, when government need to reduce inflation, increase employment, protect consumers and society, balance of payment etc. it can simply rise or reduce tax rate and decide to tax or not to tax some activities.
Taxes provide the money that makes it possible for government to function. Governments require substantial revenue for expenditure on various public services, such as the provision of health, education, defense, transport, administration of justice housing and many other services. All governments in the world depend mostly on tax revenue to achieve their roles to their citizens. Failure to collect enough tax revenue might lead to government failure or collapse of the government. Therefore tax revenues are important because of governments need to manage the economy, regulate society, develop society and provide public goods. Although these goods can be financed through other means, like loans, even when governments borrow they need tax revenue to repay them.

(b) Social purpose
The government aims to reduce the gap between poor and rich; this has been a political agenda in our country. Taxes are therefore used as a redistribution of wealth. The purpose of income redistribution is to lessen the inequalities of wealth in society. In addition to taxing the rich more than the poor government can use cash transfer system to reduce poverty and promote social equality. The effect of the system is to transfer money from those who have much of it to those who have very little. Two of the most common examples are social security payments and welfare payments made to people who, for one reason or another, do not work.

(c) Implementation of government policies

Taxation has been used as a tool of encouraging particular behaviour in a particular society. For instance tax reduction may encourage an economic activity that perhaps it could not have existed. The introduction of Export Processing Zone is one of examples which aim at encouraging exports.

(d) Environmental purpose

Taxation can be used as a regulation tool to protect the environment, domestic industries or sectors, consumers and public in general. Government can enact heavy taxes on harmful products like cigarettes, liquor, etc. hence making it expensive and discouraging its production. It is considered unlikely that individuals will contribute voluntarily to protect the environment as they are unlikely to be affected in their lifetime by the changes taking place. As a result, the government aims to protect the

(e) Other objectives of taxation include:

Encouragement of domestic industry and discouraging imports: the government may increase custom duties on imports which will increase the price of imported goods and will in turn help government to control import of goods.

Income redistribution: this refers to bridging the gap between the rich and the poor and reducing inequality.

This is done by levying higher tax on the richer sections of society. These funds are used for the welfare of the poorer sections to reduce the disparity between different sections of society. Economic stability: this refers to reducing the effect of inflation/ depression. For example, an increase in direct taxes will reduce the money available with the people to purchase goods and services and will in turn help to reduce inflation, whereas increase in public expenditure during depression helps to increase demand for goods and services, which is otherwise very low during depression. Protection of particular sectors/ industries: the government may levy lower rates of taxes or give tax concessions to particular sectors/ industries to protect or promote their growth

2. The Principles or Canons of Taxation

Taxation system should adhere to certain basic principles so that it can function effectively.

- the tax system should be fair (that is a person should be taxed according to his ability to pay),
- the provisions of tax should be clearly specified without any ambiguity,
- it should be easy to understand to the common man,
- it should be efficient and cost of compliance should be minimum.

The main principles of a good tax system are:

Equality: This is the most important principle of taxation. It means that the tax system should be framed depending on the ability of the people to pay tax that is the richer sections or the high- income group should be subjected to higher tax while relatively less tax should be imposed on the low income group

Economy: A good tax system will ensure that the cost of collecting and paying tax as well the compliance cost is minimum. For example, if there are many procedures for payment of tax and filing of related documents or if a number of visits are required by the tax payer to the tax office, then the tax system is said to be uneconomical.

In a broader sense, if very high tax is levied on the income of the tax payer, it will discourage savings and the productive capacity of the economy will go down, which will be uneconomical for the country.

Taxes on products like alchohol, cigarettes etc are considered as economical because they fetch revenue to the government as well as increase the price of those products which will discourage their consumption.

Certainty: It means that tax that each tax payer is required to pay should be certain and there should be no ambiguity. The amount to be paid, timing of payment, procedure for payment should all be certain and known to the tax payer. There should be no element of ambiguity in the taxation provisions as this may lead to corruption (if any element of taxation can be controlled by the will of the government authorities).

Certainty is also required from the point of view of the government in terms of the estimated amount to be collected from various taxes and the time frame when the same will be collected.

Efficiency: This means that the revenue collected from the tax payers in the form of tax should be sufficient to meet the government expenditure. However the government has to ensure that in order to raise sufficient revenue to meet expenditure, it does not overburden the tax payers such that the productive capacity is affected.

Understandable: Tax system should be simple and should be such that it can be understood by common man. This will help curb corruption.

Benefit principle: Taxation system should be such that persons who benefit from goods/ services provided by the government and which are primarily funded through taxation, should pay for it.

Convenience: The tax system should be so designed that it causes minimum inconvenience to the tax payers in respect to payment of tax, record- keeping, filing of returns, audits etc.

Generally indirect taxes like VAT are convenient to the consumers because a consumer pays for them when he makes purchases and at a time when he can afford to because he chooses his own time of purchasing.

Fairness / equity: Taxation system should ensure that no special treatment is meted out to specific political or other interest groups.

Demand management: In times of depression in the economy, demand for goods and services is low; government can help increase demand by reducing taxes on goods/ services and consequently, reducing prices.

Elasticity: Government should be able to increase revenues from taxation if required in case of an emergency for eg: a surcharge levied on income- tax can considerably increase government revenue during the period of emergency

Flexibility: This is a necessary criterion for elasticity. Unless the tax system is flexible that is it can be modified to suit new conditions, revenue cannot be increased.

Diversity: There should be a number of taxes both direct and indirect so that all the people who can afford to contribute are subjected to tax.

Broad basing: This principle requires that taxes should be spread as wide as possible over the sections of population/ economy, to minimise individual tax burden.

Earmarking: Tax revenue from a specific source should be used for the purpose for which it is collected when a direct link can be established between the tax collected and the expenditure for eg toll collected for road maintenance.

3. Approaches to Classification of Taxes

Taxes may be classified into different types according to various criteria like:

- tax base,
- tax incidence shift ability,
- unit or ad-valorem based taxes,\ and
- hypothecated taxes
- Distribution of tax burden.

Each of the above are explained below.

3.1 Classification according to tax base

Tax base means what is being taxed and what is no. Under this basis we have the following classes:

a. Income tax: taxed based on the quantum of income earned or received by taxpayers at specific period e.g. corporate tax, PAYE for employee etc. Income base taxes are most popular taxes all over the world but as we shall see, what constitutes income is highly debatable.

b. Wealth tax: taxed based on wealth accumulated by taxpayers. In this category we have capital gain tax, property taxes, etc. From those two bases we have income tax.

Sometimes wealth taxes can be easily measured and administered, for example land rent taxes which are based on square metres. Also wealth tax can be used to tackle tax avoidance in the tax system, for instance, if you buy shares in corporate entity you will only be taxed when you sell or receive dividends. On the other hand some of wealth taxes are difficult to administer; issue such as inflation, valuation of properties without being sold for council taxes make the wealth tax complex.

c. Expenditure tax: taxed based on taxpayers spending their income or wealth accumulated. For example value added taxes and excise duties on purchase of alcohol and cigarette. Expenditure taxes, unlike income and wealth taxes relate to taxes on consumption from an economy. Thus, we do not have to worry about valuation of income in expenditure taxes; and since taxpayers are taxed only if they spend the income or wealth, they are somehow encouraged to save. However, if we depend only on expenditure tax base, some income or wealth [savings] will not be taxed so we may end up paying high tax rate.

3.2 Classification according to ability to shift the tax incidence

Tax impact or formal incidence is legal requirement to pay tax. It refers to who is required by tax law to pay taxes while tax incidence is the actual effect / burden of paying taxes by the one who actually pays taxes. Building on this basis we have direct and direct taxes.

1. **Direct tax**
   It is a tax levied directly on tax payers (individuals and non-individuals) who are required to by tax laws to pay taxes with no possibility of shifting the incidence to another person. In this case the tax impact and incidence falls on the same person. Thus the tax is levied on and paid by the same person.

Examples of direct taxes include:

i. Income taxes
- Corporate tax - 30% of all companies (whether resident or none resident) carrying on a business in Tanzania.
- Individual Income Tax - non-corporate resident tax payers including sole proprietors and salaried employees are taxed at progressive individual income tax rates,

ii. estate duty, property tax and capital gain tax

iii. Skills and development levy - a tax on the gross monthly emoluments paid by an employer to employees. iv. Game of chance and Gambling Tax - charged to casinos, private lotteries and slot machines.

iv. Withholding taxes - a scheme, that is basically not a tax source in itself that is operated on a number of payments made by persons in course of doing businesses/investments. [e.g. investment income, etc].

(a) Benefits of Direct Taxes

The direct taxes are always regarded to be more equitable than indirect taxes because they can be related to taxpayer's ability to pay through the progressive rate structure where a change in income automatically pushes the taxpayer to the next higher or lower tax bracket without altering the tax rates.

Direct taxes also create public consciousness since the taxpayers are made to feel the burden of taxes directly and hence take keen interest in how public funds are spent. The taxpayers are likely to be more aware about their rights and responsibilities as citizens of the state

The direct taxes can help to control inflation. During inflationary periods, the government may increase the tax rate. With an increase in tax rate, the consumption demand may decline, which in turn may reduce inflation.

The direct taxes are relatively elastic. With an increase in income and wealth of individuals and companies, the yield from direct taxes will also increase. Elasticity also implies that the government's revenue can be increased by raising the rates of taxation. An increase in tax rates would increase the tax revenue.

As far as direct taxes are concerned, the tax rates are decided in advance therefore the tax payer is certain as to how much he is expected to pay. The Government can also estimate the tax revenue from direct taxes with a fair accuracy.

(b) Criticisms of Direct Taxes

An important criticism of direct taxes is the possibility that highly progressive direct taxes may have serious disincentive effects. It may reduce people's ability and willingness to work and save and thus have a negative impact on investment and productive capacity in the economy. If tax burden is high, people's consumption level gets adversely affected and this has an impact on their ability to work and save. High taxes also discourage people from working harder in order to earn and save more.

In direct tax burden of tax cannot be shifted. The disadvantages of direct taxation are therefore mainly due to administrative difficulties and inefficiencies. The extent of direct taxation should depend on the economic state of the country. A rich country has greater scope for direct taxation than a poor country.

Direct taxes are inconvenient in the sense that they involve several procedures and formalities in filing of returns. For most people payment of direct tax is not only inconvenient, it is psychologically painful also. When people are required to pay a sizeable part of their income as a tax to the state, they feel very much hurt and their propensity to evade tax remains high.

It is also argued that direct taxes are prone to tax evasion. Indeed compared to indirect taxes it is said that direct taxes are easier to evade. The tax evasion is due to high tax rates, documentation and formalities, and poor and corrupt tax administration. It is easier for the businessmen to evade direct taxes. They invariable suppress correct information about their incomes by manipulating their accounts and evade tax on it. In due to high rate of progressive tax evasion & avoidance are extensive.

The direct taxes tend to be arbitrary. Critics point out that there cannot be any objective basis for determining tax rates of direct taxes.

2. Indirect tax

It is a tax whose incidence can easily be shifted to another person from a person who is required to pay it by law. In other words tax incidence in indirect taxes falls on another person than the one paying the tax. For example VAT is paid by a consumer to a retailer / manufacturer, at the time of purchase of goods. However the retailer / manufacturer is required to pay this tax (which is collected) to the government. The ability of taxpayers to shift tax incidence to others depend on a number of factors such as market structures, industry cost structure, price elasticity of product, and types of tax.

When taxpayers are operating in imperfect market as monopoly, oligopoly, and duopoly where products are differentiated and there is imperfect communication, tax incidence may easily be shifted. It is difficult to shift tax burden in perfect market containing many buyers and sellers, full knowledge, no restrictions of exist and entry as small increase in price lead to significant decrease in sales.

In increasing cost structure any attempt to shift the tax incidence will increase the price of goods that are probably perceived already high by taxpayers. Therefore a rational taxpayer cannot try to shift tax incidence in that situation. Taxpayers can possibly shift tax burden in constant cost structure and justify it to his/her customers, but he/she can easily put the tax burden on customers shoulder in decreasing cost structure simply by maintaining the price.

The price elasticity of product describes the demand changes due to a change in prices. The product is elastic if small change in price leads to great change in demand hence less possibility of shifting tax incidence in respect to that product. If a change in price leads to a very small change in demand the price elasticity is said to be inelastic, and in this situation there is very high possibility of shifting tax incidence.

Generally if tax is classified as indirect tax there is more possibility of shifting tax incidence while in direct tax it is not easy to shift tax incidence as tax authority identify and charge tax direct to the tax payer.

Examples of indirect taxes include:

- Excise duty on locally manufactured goods - levied on locally manufactured goods which includes beer, wines, whiskeys, spirits, soft drinks, smoking tobacco, cigarettes, and petroleum products.

- Stamp duty - certain legal instruments attract payment of stamp duty for the purpose of authenticating them.

- Value Added Tax (VAT) - a consumption tax charged on VAT registered traders for goods and services at a standard rate of 18%.

- Other Internal Taxes such as fees, levies and user charges, which are collected from various sources. For example. taxes and charges on motor vehicles, port and airport departure services.

- Import duty or customs duties. These are tariffs, which are imposed on goods coming into the country.

- Excise duty on imports of certain consumer goods into the country.

1. Advantages of Indirect Tax

Indirect tax is convenient to both the Government and the taxpayer. It is convenient to taxpayer as the taxpayer do not feel the burden much because they do not pay a lump sum amount for tax and that tax is paid only when making purchases. Moreover, the tax is "price-coated" i.e it is wrapped in price and therefore the burden cannot be easily felt. It is convenient to the Government as well because the business owners collects the tax on the Government's behalf when they charge a price.

There is mass participation. Each and every person getting goods or services has to pay tax. Indirect taxes are the only means of reaching the poor who are always exempted from paying direct taxes. It is a sound principle that every individual should pay something, however little, to the Government.

Unlike direct taxes, the indirect taxes have a wide coverage. Majority of the products or services are subject to indirect taxes. The consumers or users of such products and services have to pay them.

Indirect taxes can be used to influence pattern of production by imposing taxes on certain commodities or sectors, the government can achieve better allocation of resources. For example by Imposing taxes on luxury goods and making them more expensive, government can divert resources from these sectors to sector producing necessary goods.

When imposed on luxuries or goods consumed by the rich, indirect taxes are considered equitable as only the well-to-do will pay the tax.

Indirect taxes are very elastic in yield, if imposed on necessity goods which have an inelastic demand and therefore can yield very large revenue, because people must buy these goods. However the dilemma of indirect taxation is the fact that it is based on consumption and therefore hits the majority of lower income earners.

There is a less chance of tax evasion as the taxpayers pay the tax collected from consumers. They cannot be evaded, as they are a part of the price. They can be evaded only when the taxed commodity is not consumed, and this may not always be possible.

The government can check on the consumption of harmful goods by imposing higher taxes to those goods such as tobacco, and other intoxicants.

The indirect taxes may not affect the motivation to work and to save. Since, most of the indirect taxes are not progressive in nature, individuals may not mind to pay them. Therefore, individuals would not be demotivated to work and to save, which may increase investment

The indirect taxes are more flexible and buoyant. Flexibility is the ability of the tax system to generate proportionately higher tax revenue with a change in tax base, and buoyancy is a wider concept, as it involves the ability of the tax system to generate proportionately higher tax revenue with a change in tax base, as well as tax rates.

2. Disadvantages of Indirect Tax

The biggest criticism of indirect taxes, is that they do not take into account the taxpayer's ability to pay both the rich and the poor pay exactly the same amount of tax. It is therefore regressive because tax burden to the rich and poor is the same making the poor spending a greater percentage of their income than the higher income earners. This may further increase income disparities among the rich and the poor.

Indirect tax is uncertain. As demand fluctuates, tax will also fluctuate. Unless necessities are taxed (which is normally not the case) the yield is uncertain. Taxes on commodities with elastic demand are particularly uncertain, since quantity demanded will greatly be affected as prices go up due to the imposition of tax. In fact a higher rate of tax on a particular commodity may not bring in more revenue. When the commodity is not purchased, the question of the tax payment does not arise.

Indirect tax has a direct effect on consumption, production and employment. For instance, a high rate of duty on certain products such as consumer durables may restrict the use of such products. Consumers belonging to the middle class group may delay their purchases, or they may not buy at all. The reduction in consumption affects the investment and production activities, which in turn hampers economic growth.

Most of the taxes are concealed in the price of goods or services. As a consequence, the tax-payer does not even know that he is paying a tax let alone know the amount of tax he paid to the Government.

They are uneconomical. The cost of collection is quite heavy. Every source of production has to be guarded.

The government has to set up elaborate machinery to administer indirect taxes. Therefore, cost of tax collection per unit of revenue raised is generally higher in the case of most of the indirect taxes.

The indirect taxes are inflationary in nature. The tax charged on goods and services increase their prices as taxes are shifted forward.

3.3 Classification according to quantities or values

There are two types of taxes under this category: us unit and ad-valorem taxes.

A unit or specific tax is levied on the physical measures of what is being taxed e.g. volume, weight, square meters like land and property taxes etc.

Examples

Items charged under specific rates in Tanzania include: Wine, spirits, beer, soft drinks, mineral water, fruit juices, Recorded DVD,VCD,CD and audio tapes, cigarettes, tobacco, petroleum products and Natural gas.

Ad-valorem tax is levied on the value of the tax base, for example income tax is charged on the level of income, VAT on consumer expenditure and import duty.

Examples

Items charged under ad-valorem rates include: Money transfer services, electronic communication services, pay to view television services, imported furniture, motor vehicles, plastic bags, specified aircrafts, firearms, specified cases, cosmetics and medicaments.

Ad-valorem rates are: 0%, 0.15%, 5%, 10%, 17%, 15%, 20%, 25% and 50%.

One advantage of ad valorem taxes is that the tax revenue to the government can rise automatically as the economy grows. This means that the tax rate does not need to be adjusted frequently, as in the case of specific unit taxes, such as duties on cigarettes and alcohol.

Specific taxes versus ad-valorem taxes

Specifi	Ad-
A Specific Tax is a system of taxation where the level of tax is fixed and independent of the value of the item being purchased.	An ad valorem tax is a tax based on the value of real estate or personal property. It is specified as a proportion of the product price.
The tax rate needs to be adjusted frequently, as in the case of specific unit taxes, such as duties on cigarettes and alcohol.	The tax revenue to the government can rise automatically as the economy grows. This means that the tax rate does not need to be adjusted frequently, as in the case of specific unit taxes, such as duties on cigarettes and alcohol.
A specific tax is typically imposed at the time of a transaction.	An ad valorem tax is may be imposed at the time of a transaction (a sales tax or value-added tax (VAT)), or it may be imposed on an annual basis (real or personal property tax).

3.4 Classification for hypothecated taxes

The hypothecation of a tax (also known as the ring fencing or ear marking of a tax) is a tax where the money obtained, or part of the money obtained, is used for a particular purpose, rather than spent on a number of things. These are taxes that are raised to pay for specific activities.

Example

Rural energy fund, taxes charged when we buy electricity from TANESCO and skill and development levy paid by employers to raise fund to the Vocational Education and Training Authority (VETA) for the purposes of providing the skills to the workforce that employers require the levy is also used to finance the Higher Learning Students Loan Board [HLSLB].

Another example in many European countries is a television license. There, all users of television sets are obliged to pay the government an annual fee to use their televisions. The proceeds of the levy are then used to fund public broadcasting.

Dedicating tax revenues to specific expenditures can however be used by policymakers to mask increases in total government spending, and it has been shown empirically that hypothecated taxes tend to result in an increase in total government size but have little effect on the expenditures to which they are tied.

3.5 Classification according to distribution of tax burden fairness

Under this categorization we have progressive, proportion and regressive taxes.

1. **Progressive taxes:** as income rises so does the proportion of tax i.e. the rate of tax rises as well as the amount of tax. Furthermore in this case marginal rate of tax is greater than the average rate of tax. This can be considered as just and fair, as the higher tax payments are made by those with higher incomes. Taxes which take a higher percentage of the incomes of higher income earners are said to be progressive.

2. **In proportional taxes** the amount of tax to be paid increases in the same way as the rise in income or any tax base. It occurs when marginal rate of tax and average rate of tax being equal, good example all tax payers paying 10% constant of their income.

3. **Regressive taxes increase** slower than the rise in income and the marginal rate of tax (MRT) is less than average rate of tax (ART). As income rises, the proportion of tax decreases, e.g. the tax on a packet of cigarettes remains the same, regardless of the income of the consumer. Regressive taxes can be justified as smokers are likely to require additional hospital care, which is the reason why they should contribute towards the cost of it. Taxes which take a higher proportion of the incomes from lower income earners are said to be regressive.

Most of income and wealth taxes belong to either progressive or proportion taxes which mean that the richer pay more in progressive tax while they (the rich) suffer the same as poorer in proportional tax.

Example

In progressive tax system taxpayers will end up paying different tax rates depending on their incomes, with the higher income earner attracting high tax rate.

Assume that Mrs Kanje earns Tshs 1,000,000 per month which is subjected to say 20% tax rate under PAYE and her friend Mrs. Swabiri gets Tshs 200, 000 per month which is taxed at say 10% under PAYE. You will end up paying different taxes under progressive tax system, you pay Tshs 100,000 and she/he pays 20,000 to TRA.

If it was proportional tax system they would all be subjected to the same tax rate, for example 20%, Mrs Kanje would pay Tshs. 200,000 and Mrs. Swabiri would pay 40,000.

In the regressive taxes wealthy taxpayers spend proportionally less of their income than poorer. Consequently, the poor spend much of their income in paying regressive taxes. In regressive system taking the example, Mrs Kanje and Mrs. Swabiri buy food at Bestbite for Tshs 10,000 assume it includes Tshs 1,000 as VAT. The richer (Mrs Kanje) would have spent 1,000/1,000,000=0.1% paying for taxes in this transaction, while poorer (Mrs. Swabiri) would have spent 1,000/200,000=0.5% paying for VAT significantly above the richer (Mrs Kanje) burden.

Marginal rate of taxation (MRT) and Average Rates of Taxation (ART)

The marginal and average rates are very important to both government and taxpayers. Marginal rates of taxation is the rate of tax which is due if taxpayers earn Tshs 1 more than their current income. The average rate of tax is the total amount of tax paid as a proportion of their total income.

$$MRT = \frac{\text{Change in tax paid or amount of tax paid on next Tshs1on Income}}{\text{Change in income}}$$

$$ART = \frac{\text{Total tax due}}{\text{Total income}}$$

The taxpayers care more about the marginal rate of tax than average rate of tax as it shows how much they are going to pay as taxes for an increase in income. Take an example of employed taxpayers who want to work overtime to earn more income, the progressive nature of our payroll taxes mean that the extra income will be taxed more. Progressive taxes may discourage hardworking individuals, while the government can induce hard working spirit through decreasing the marginal rate of taxation.

Example

Compute the marginal rate of tax and average rate of tax from following information:

	Income	Tax paid
2	1,5	4
2	2,0	6
2	2,5	7
2	3,0	9

Answer

Marginal rate of tax is given by change in tax paid over change in income giving the following results.

	Change in	Change in tax	Marginal rate of
2			-
2		1	30
2		1	30
2		1	30

While the average rate of tax is total tax paid/total income.

	Income	Tax paid	Average rate of
2	1,5	4	450,000 / 1500,000
2	2,0	6	30%
2	2,5	7	30%
2	3,0	9	30%

Comment: this is a proportion tax system as marginal and average rate of tax are equal.

4. Theory Of Equity In Taxation

4.1 The Benefits Theory.

According to the benefits theory, tax burden should be split up according to the benefit gained from the government expenditure that are funded by taxation. The persons who receive benefits from the government should pay amount as taxes which are equivalent to the benefits received. Therefore those who receive greater benefits should pay more as taxes than those receiving less benefits. The government should not impose taxes greater than the benefits received by the tax-payer. If the taxes are greater than the benefits received, then the tax system would not be equitable one.

Under the benefit principle therefore, taxes are seen as serving a function similar to that of prices in private transactions; that is, they help determine what activities the government will undertake and who will pay for them. If this principle could be implemented, the allocation of resources through the public sector would respond directly to consumer wishes.

Example
The following are examples of the public services that are currently funded, in some part, on the basis of the benefit principle.

- Public college tuition fees (only paid by the people who attend public colleges)
- National park admission fees (only paid by the people who visit public parks)
- Fuel taxes (only paid by the people who purchase fuel)
- Bus fares (only paid by the people who take the bus)
- Bridge tolls (only paid by people who use the bridge)
- Road license tax paid by motor vehicle owners

The application of the benefit theory
The principle of benefit arises from the need that greatest beneficiaries should make the greatest tax contribution. This is indeed the essence of **fairness**. It **finds common application in near public goods whereby only those who pay and consume the goods are liable fo**r such taxation.
The benefit principle is utilised most successfully in the financing of bridges, roads and highways through levies on motor fuels and road-user fees (tolls). In these specific cases, it is easy to implement tax according to the benefits received because it is possible to quantify a direct and reasonable benefit.

Formidable examples include tourist paying their levies, students paying for their tuition, patients paying for their medical charges among many other instances. The people who do not directly benefit from such goods and services are thus exempted from the associated charges. Such manner of fairness is elaborately justifiable. Under the benefit principle each individual pays for the amount of government provided goods and services they consume. Because the exchange is voluntary, at least as envisioned by many promoting this principle, and payments are in accordance with benefits, it satisfies this notion of equity.

In the absence of benefit taxation, it is impossible to tax persons who benefit from a specific government project. For example: If the government does not follow the principle of benefit, and imposes tax on the basis of ability to pay, then it would end up in imposing tax upon people in Musoma for meeting the expenditure of a bridge constructed in Kigamboni making persons in musoma, who do not use the bridge, worse off. This unfairness in taxation can be avoided, if the government follows the benefit principle.
Limitations of Benefit theory

Although simple in its application, the benefit theory has the following difficulties in its application:

i. Despite the logical fairness identified in the principle of benefit, it s**uffers a setback in terms of efficiency** Inefficiency in provision of goods is based on the notion that there would be a decline in quantity demanded if direct beneficiaries pay a price equal to the derived value as it is for private goods.
ii. The principle is based on the assumption that it is possible to determine the benefit received for every individual for each government expenditure. However, the implementation of this principle faces daunting challenges on public goods. Excluding non-payers and identifying the received benefits is complicated thus making it almost impossible to set the amount of tax. In some public expenditures such as defense, fire force, expenditure in advanced scientific research etc the benefits available to each individual is very difficult to calculate separately.

iii. **It is difficult to trace benefits (example defense, justice, law and order) to each individual in the society**. So the application of this principle depends on the person himself to reveal information about the amount of benefits he receives. But citizens generally have no inclination to pay for a publicly provided service such as a police department unless they can be excluded from the benefits of the service.

iv. In modern times, government is welfare oriented with the objective of increasing the welfare of the society as a whole. It is thus impossible to individualize the benefits rendered to the society. Therefore, an individual cannot be taxed but the taxation should be taken as a collective instrument for supporting the services of the government.

v. Under the benefit principle the rich and poor people pay equal tax for the same benefits received. However since the marginal utility of income of rich people is lower than the poor people, it is unjust to tax both rich and poor equally. Therefore **the principle ignores the income re-distribution objective of taxation** that requires the government to take away income from rich people by way of higher taxes and give it to poor people.

vi. Again, it can be argued that **some services provided such as infrastructural development and national defense may benefit everyone but not in equal proportions**. A criterion for identifying the major beneficiaries in such scenarios may therefore be erratic. Indeed it is difficult to establish who benefits more. The benefit received from government spending might be used as a way of determining vertical equity where persons enjoying many services pay more taxes than others. For example, road taxes are paid only by all taxpayers who own motor vehicles, while this can be seen as fair, but other road users are not contributing toward it. Is it proper for elders to pay more taxes because are more likely to be sick and enjoy free health services than youths who pay for the services? It is still problematic. Some benefit received are difficult to trace to taxpayers, for instance, how can we measure the cost of service of the police, armed forces, or judiciary to different individuals. And if taxes base on tax benefit received, then the poor will have to pay the heaviest taxes, because they benefit more from the services of the state than the rich.

vii. The benefit theory holds that the rich benefit more from protection because their property is more valuable; if those with higher incomes also consume more government provided resources, then this would justify a progressive tax structure. But which income groups use the most resources is an empirical question. If lower income groups consume more government goods, then this could also support a regressive structure. However the *cost* of protection may have little relation to the value of the property

4.2 The Ability to Pay Theory

The “ability to pay” principle suggests **that people with higher incomes should pay more than those with lower incomes**. However the principle does not answer the question of how much more. Its policy implications are based on a diminishing marginal benefit of a dollar assumption: **the widely-accepted belief that the value of an additional dollar of income falls, as income rises,** i.e. a rich man values an additional dollar less than a poor.

The ability-to-pay approach treats government revenue and expenditures separately. Taxes are based on taxpayers’ ability to pay; there is no quid pro quo. Taxes paid are seen as a sacrifice by taxpayers, which raise the issues of what the sacrifice of each taxpayer should be and how it should be measured. Potential measures of “equal sacrifice” include equal absolute sacrifice (each person's welfare declines by the same amount), equal proportional sacrifice (each person's welfare declines by the same proportion), and equal marginal sacrifice (each person's "displeasure" from taking away an additional dollar is the same). **Equal absolute sacrifice** would suggest proportional taxation if the marginal benefits of a dollar of income fell proportionally with income.

Example

Based on the above principle, if James earns $25,000 and Jack earns $5,000 during 20X3 and John values a dollar approximately a fifth as much as James, then for every dollar one collects from John, one collects $5 from James.

In the above example, the principle implied a proportional tax system.

If the marginal benefit of a dollar diminishes, but at a fairly slow rate, a regressive tax system could also be consistent with the principle, while if it diminishes at a faster rate, a progressive tax would be appropriate.

An alternative measure of sacrifice is **equal proportional sacrifice**. This method is much more likely to justify progressive tax system, but it too depends on how fast the value of an additional dollar declines with income. There are many reasonable functional forms that do not support progressivity.

The equal marginal sacrifice principle **suggests steeply progressive taxes that will collect the least valued dollars in the economy**. The result also uses the assumption that the **value of a dollar falls as income rises**. Under this principle, in contrast with the previous two cases, the progressivity does not depend on the rate with which the value declines.

Thus, without further information on the nature of welfare and the exact standard to be used, **the ability to pay criterion does not necessarily justify regressive, proportional, or progressive taxes**. The **equal marginal sacrifice principle suggests an extreme degree of progression**

Application of the ability to pay theory

Due to the inconsistencies in the benefit principle, the ability to pay principle forms a better alternative for equity in taxation. The principle suggests that the ability to pay should form basis of taxation to maintain fairness. This means that citizens who earn more should pay more taxes than their counterparts in lower income cadres. In spite of everyone sharing the benefits, only those who can afford are taxed accordingly. The principle correctly addresses the concerns of efficiency since goods are provided to citizens at zero prices and tax payment is not pegged on the beneficiaries alone.

The ability-to-pay approach treats government revenue and expenditures separately. Taxes are based on taxpayers' ability to pay; there is no quid pro quo. The approach also makes a great deal of sense, especially for the provision of public goods that are consumed by all. If everyone benefits from public goods, without exclusion, then everyone should pay. However, not everyone can pay, so those who can afford to pay need to bear the burden.

Because taxes are a means of transferring the purchasing power of income to governments, the ability to pay is based on income. Those who have more income can afford to pay more taxes, that is, they have a greater ability to pay.

Analysis of tax equity is concerned with the distribution of tax burdens among persons in different economic circumstances, i.e., with vertical equity as well as persons in essentially the same economic circumstances— horizontal equity.

Limitations of Ability to Pay Theory

Although the ability to pay approach is more popular, the main challenge lies on the determination of the 'ability to pay'. Ability to pay is mostly determined by income, wealth or expenditure. Wealth is however considered as a poor indicator of one's ability to pay because property may not be easily convertible into cash with which to pay tax. A progressive tax structure based on wealth may thus run on serious liquidity problems.

Furthermore we can measure ability to pay by expenditure incurred by a taxpayer. However this may be inequitable or unfair as taxpayers with many dependents may expend more and hence end up paying more taxes.

Lastly, ability to pay can be measured by an income base which is the most accepted measure of the ability to pay. In fact the ability to pay approach assumes "income" to be the basis for the ability to pay. Individuals with higher income is not only better able to bear the tax burden than the lower income earners, but they can bear heavier tax burdens of tax. A tax system that takes away proportionately more income from the higher income earners than from the lower income earners is known as a progressive tax system. On the other hand a tax system that takes away proportionately more income from the lower income earners than from the higher income earners is known as a regressive tax system

4.3 The Sacrifice Theory

This theory emerged from discussions of "ability to pay" theory in which taxes paid are seen as a sacrifice by taxpayers. Although it is now decidedly going out of fashion, the many variants of the "sacrifice" approach are similar to a subjective version of the "ability-to-pay" principle. **Under this doctrine, ability to pay is assumed to increase as incomes increase, and the objective is to impose taxes on a basis that would involve "equal sacrifice" in some sense**. Tax payers should make equal sacrifices in contributing to the cost of the government activity. However there is disagreement about whether there should be equal absolute sacrifice, where the rich and the poor should suffer the same absolute decline in utility

The sacrifice theory divides into three main branches:

(a) Equal sacrifice*:* The total loss of utility as a result of taxation should be equal for all taxpayers (the rich will be taxed more heavily than the poor).

(b) Equal proportional sacrifice*:* The proportional loss of utility as a result of taxation should be equal for all taxpayers.

(c) Equal marginal sacrifice*:* The instantaneous loss of utility (as measured by the derivative of the utility function) as a result of taxation should be equal for all taxpayers. This will entail the least aggregate sacrifice (the total sacrifice will be the least).

The Assumptions of Sacrifice Theory

The theory rests on three general premises:

- The utility of a unit of money to an individual diminishes as his stock of money increases;
- These utilities can be compared interpersonally and thus can be summed up, subtracted, etc.; and
- Everyone has the same utility-of-money schedule.

The assumptions of sacrifice theories that the relative utility of different incomes is measurable and that the relation between income and utility is approximately the same for all taxpayers—cannot be verified by actual data or experience. The marginal utility of money does diminish, but it is impossible to compare one person's utilities with another, let alone believe that everyone's valuations are identical. Utilities are not quantities, but subjective orders of preference. Any principle for distributing the tax burden that rests on such assumptions must therefore be declared fallacious. Nevertheless, the ability-to-pay idea has been a powerful force in history and has undoubtedly contributed to the widespread acceptance of progressive taxation. However, several aspects of this theory are of interest. Utility and "sacrifice" theory has generally been used to justify progressive taxation, although sometimes proportional taxation has been upheld on this ground. Briefly, a dollar is alleged to "mean less" or be worth less in utility to a "rich man" than to a "poor man" ("rich" or "poor" in income or wealth?), and therefore payment of a dollar by a rich man imposes less of a subjective sacrifice on him than on a poor man. Hence, the rich man should be taxed at a higher rate. Many "ability-to-pay" theories are really inverted sacrifice theories, since they are couched in the form of **ability to make sacrifices**.

Describe the criteria for evaluating taxes, discuss economic effects of taxation, explain the incidence of taxation, and explain the concept of tax buoyancy and elasticity and taxable capacity.

[Learning outcome e, f, g, and h]

5. The Criteria for Evaluating Taxes

Designing a tax system has always been a subject of considerable controversy. Any tax system influences behavior since the government takes away money from an individual, who may respond in some way to lower his/her tax liability.

a) Economic efficiency- a good tax system should not interfere with the efficient allocation of resources. To do so, it should minimize distortionary and disincentive effects to work and savings which may affect economic growth.

- Generally, almost all resource allocation decisions in the economy are affected in some way by taxation.
- A tax system is non-distortionary if and only if there is nothing an individual can do to alter his tax liability. Non-distortionary taxes are sometimes referred to as **lump-sum** taxes.
- Any tax on commodities is distortionary since an individual can change his tax liability by reducing his purchases of the commodity. A tax on income can also be distortionary if an individual can reduce his tax liability by working less or by saving less.
- Taxation can sometimes be used in a positive way to raise revenue while at the same time correcting market failure/externalities and thus improving efficiency of resource allocation.

b) Administrative simplicity- a good tax system ought to be easy and relatively inexpensive to administer. There are significant costs associated with administering the tax system:

(i) Direct (administrative) costs- the costs of running the tax authority.
(ii) Indirect (compliance) costs- the costs which taxpayers must bear-including the costs of time spent filling out the tax forms, costs of record keeping, and costs of hiring accountants and lawyers. Indirect costs are usually about five times greater than the direct costs.

- The overall administrative costs of running a tax system depends on the extent of record keeping, the complexity of the tax system (number of taxes and rate structure), extent of tax evasion and level of enforcement required, and the type of income being taxed (taxing capital is more expensive than taxing labor-where tax is mostly withheld at the source).

c) **Fairness/Equity**-a good tax system ought to be fair in its relative treatment of different individuals.

(i) Horizontal equity- a tax system is horizontally equitable if individuals who are the same in all relevant respects are treated equally.

(ii) Vertical equity- a tax system is vertically equitable if individuals who are in position to pay higher taxes than others actually do so. Progressive taxation is usually used to accomplish this.

- Decisions about who should pay more than another may be based on ability to pay, higher level of economic wellbeing, or receipt of more benefit from general government spending. In most cases the level of income is used as the basis for measuring economic wellbeing and hence ability to pay.

(iii) To be fair the tax system should not be characterized by arbitrariness or uncertainty about tax liability; should be based on observable and measurable variables of welfare such as income or expenditure; and should also not be inconvenient with respect to the timing and manner of payment.

d) **Flexibility**- a good tax system ought to be able to respond easily (automatically) to changed economic circumstances in order to counteract fluctuations in the level of economic activity.

- Changes in economic circumstances require changes in tax rates. For some tax structures (e.g., where ad valorem tax rates in a progressive fashion are used) these adjustments are easy and automatic; but for some they require extensive political debate/approval by Parliament thus making the tax system adjust inflexibly with a lag.

e) **Political Responsibility**- the tax system should be designed so that individuals can ascertain what they are paying so that the political system can more accurately reflect the preferences of individuals.

- Governments should not try to take advantage of uninformed taxpayers/citizens by using mostly taxes whose burden is not so apparent.

6. Economic Effects of Taxation

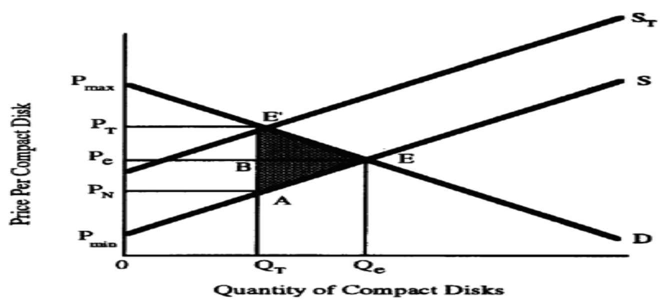
6.1 Tax effects on Consumer and Producer Surplus

In a market without taxes, the difference between the market price of a good and the highest amount consumers would be willing and able to pay for it is referred to as consumer surplus. Consumer surplus occurs because first, every consumer has his own maximum price he would be willing to pay for a good (although the market aggregates this demand, along with supply, to produce a market price); secondly, is due to the fact that demand is rarely perfectly elastic. For most goods there is a limit to how much or how little consumers will buy, no matter how much the price changes. For example, people are unlikely to stop buying bread if the price rises, and they are unlikely to buy a lot more bread if the price falls. In effect, consumer surplus can be seen as the total use or value that consumers get without paying for it. On the other hand producer surplus represents the difference between the market price and the lowest amount for which producers would be willing and able to sell a good in a market without taxation. It is possible -- and, in fact, normal -- that there will be consumer surplus and producer surplus for the same good. In the same way each consumer has her own maximum price for a good, each producer has a minimum price for the good. In most cases, this is at or slightly above the producer's costs, because there is no benefit to producing and selling more cheaply than this. In effect, producer surplus means profit.

Tax Effect

The addition of the tax will also remove some consumer and producer surplus. Consumers are forced to pay more for the same good because the price has risen. Meanwhile, producers are losing out on potential profits because their revenue has not increased by as much as the price rise would suggest. Total surplus will therefore be reduced, because people and firms sell or buy less of a good when the tax adds to its price. The effective price paid may rise, causing the demand curve to shift to the left, or the effective price received may fall, causing the supply curve to shift to the left, creating the Deadweight Loss. This means that some people that would have engaged in trade without the tax, no longer are "willing and able" to buy or sell the good, meaning their surplus disappears, and the tax revenue that would have been derived from their market participation disappears as well. Thus, taxes always cause deadweight Losses for society and always negatively affects the free market system.

Graphic example of the effect of sales tax on producers and consumers



The initial equilibrium is at point E, with price P_e and quantity Q_e. At the outset, the gains from trade are shown by $P_{max}EP_{min}$, allocated as before between consumers and producers. Suppose now that the government imposes a per unit sales tax of say, TZS *T* per disk on the sale of compact disks (A to E'). We know that the tax raises the costs of production by TZS*T* for each disk that is produced. As a result, the industry supply curve shifts up vertically by the TZS*T*, leading to a higher equilibrium price, P_T and a lower equilibrium quantity, Q_T. The impact of the tax on consumers' surplus is clear: From consumers' perspective, the price of disks rises, and they reduce consumption in response. Instead of enjoying a surplus of $P_{max}E'P_e$, they now must make do with the smaller surplus $P_{max}E'P_T$. Thus, consumers lose the area $P_TE'EP_e$.

As viewed by producers, the tax-inclusive price of CDs rises to P_T, but of course TZS*T* per disk must be handed over to the tax collector. Thus, the net (after-tax) price received by sellers falls to P_N (which equals (P_T - T)). The new level of producers' surplus is shown by the triangular area P_NAP_{min}, which is clearly smaller than before the tax. Indeed, producers lose the area P_eEAP_N

6.2 Tax Effects on Demand and Supply

Putting a tax on a good distorts the relationship between demand and supply. Taxes have an effect on the amount of supply produced and consumer's demand for goods. Taxation puts both consumers and producers in a worse position because with the introduction of taxes, the price that consumers pay is higher than what they would have paid before. On the other hand, the price that producers get after the introduction of taxes is lower than what they would have received before taxation.

The resulting change in relative cost of goods and services will have an effect of motivating consumers to switch from one product or activity to another. The act of switching from one product to another as a result of a tax, given a certain income level, leads to substitution effect. The substitution effect interferes with consumer choice and subsequently leads to economic inefficiency. Taxes that affect relative prices and influence consumers to substituting consumption of the taxed commodity for another are also termed distortionary taxes and the substitution changes the consumer's tax liability. The distortionary effects are not limited to commodity tax alone but are also associated with tax on income as an individual may decide to reduce his tax liability by working less as will be shown in the following sections.

The market has narrowed because lower quantity of goods is being exchanged. The decrease in consumers' and producers' welfare turns into tax revenue of the state. Thus, for the purpose of full understanding of the impact of taxes on welfare, the decrease in welfare of consumers and producers should be compared with the tax revenue collected by the state. Such an analysis will show that the decrease in consumers' and producers' welfare exceeds the tax revenue collected by the state. The loss of welfare that takes place after introduction of taxes (a part of which belongs to no one - neither to a consumer or producer, nor to the state) represents a dead weight loss or excess tax burden, or a degree of inefficiency that taxes introduce to economy.

6.3 Tax effects on savings

Taxes can reduce economic growth by affecting savings and investment. The higher the proportion of income that is being saved and invested, the higher will be the future income level. In other words, through its impact on the amount of the income being saved or invested, taxation policy has a crucial effect on the future level of income per capita. The effect of taxes on saving (of individuals and companies) is briefly presented below.

6.3.1 Impact of Taxes on Savings of Individuals

The gross savings in private sector are accumulated in households and companies. However, a large part of the gross savings is used for covering depreciation and is needed for the maintenance of the existing capital. The net savings, consisting of savings in households and retained earnings of companies, represent the real potential, available for new investments. The major part of these savings is accumulated in households, while the retained earnings account for only a small part of them. If all individuals would save the same proportion of income, then the impact of income tax on the total savings would be the same, regardless of the pattern of the distribution of tax burden to individuals. But, wealthy individuals save more than poor citizens, so it is expected that the taxes collected from higher tax brackets create more burden on savings than the ones collected from lower tax brackets. Consequently, a more progressive income tax seems to be creating a heavier burden on savings than a less progressive tax system. This claim suggests that a less progressive income tax system would be favorable to the increase in savings of individuals. However, research has established that the impact of income progressiveness on level of savings is much less important than it could be expected: replacement of progressive income tax with a proportional one could increase household savings by not more than 10 percent. This implies that propensity to save is affected by other non-tax factors: for example it varies with stage in a life cycle: in youth and in old age it is much lower than in middle age when income is highest and when people save for education of their kids, for a house or a flat and for the old age. Income tax also affects savings by lowering the net return from savings, that is, by lowering the interest rate on savings. In such conditions, savings are expected to drop. However, the savings of individuals are motivated with various other reasons and their final amount does not have to depend on interest rate trends only. For example, many households will not save less when interest rates are lower, because they are in that part of life cycle when they have to save for retirement. Besides income tax, consumption tax also affects savings of individuals. While income tax is generally progressive, consumption taxes are mostly regressive, that is, they are mostly paid by lower-income households. Since these households have a higher marginal propensity to consume than the households with higher income and since their marginal propensity to save is lower than the one of wealthy individuals, consumption taxes burden total consumption more and savings less. This is why it is often recommended to the countries with low level of savings that they should direct their tax systems to taxation of consumption much more, because this will boost savings and growth, too.

6.3.2 Impact of tax on gross savings of companies

Retained earnings and depreciation reserves account for the predominant part of company savings. Since profit is taxed after deduction of depreciation, income tax does not reduce the depreciation reserves. But if profit taxation law allows accelerated depreciation, then depreciation reserves and company savings will increase in the first years following the purchase of fixed assets. Profit is divided in the dividends distributed to company owners and undistributed profit remaining in the company. Different taxation of the dividends and retained profit has an impact on savings, too. Higher taxation of the retained profit will stimulate its distribution to dividends, while lower taxation of the retained profit will increase the company's savings. The amount of savings also depends on whether profit taxation system and income taxation system are reconciled. If they are, double taxation of the dividends on company level and again on the level of individuals is thus avoided.

6.4 Tax effects on labour supply

In regard to the labour market, labour is the supply and wages are the price of labour. Because the supply of unskilled labour is highly inelastic, unskilled workers bear most of the burden of the payroll tax. However, when workers offer valuable skills, they are generally much more highly compensated because there is more competition for their abilities and services. Thus, highly compensated individuals bear less of the burden of the payroll tax than the employers. The overall effect is that the tax incidence of the payroll tax falls more heavily on lower income workers than on higher income workers.

6.4.1 Impact of income tax on wages and employment

Taxation of labour introduces a difference between real gross cost of labour for a company and real net wage that employees receive. Thus, taxes create a difference between the cost of labour and net wage that is called tax wedge in economic theory.

Tax wedge is the difference between before-tax and after-tax wages. The tax wedge measures how much the government receives as a result of taxing the labour force.

In some countries, the tax wedge increases as employee income increases. This reduces the marginal benefit of working therefore employees will often work less hours than they would if no tax was imposed. Some argue that the tax wedge on investment income will also reduce savings, create less innovation, and ultimately lowers living standards. By having a tax wedge the inefficiency will cause the consumer to pay more and the producer to receive less. This is due to higher equilibrium prices paid by consumers and lower equilibrium quantities sold by producers.

Tax wedges are the basic value with which impact of tax on labour market, that is, on the amount of supply and demand for labour is analysed. The amount of real gross cost of labour determines the amount of labour demand, while the amount of real net wage determines the amount of labour supply. What part of tax wedge will be distributed on the entrepreneur, thus determining the labour demand, and what part of tax wedge will be distributed on the employee, thus influencing the amount of labour that he can supply to the market, depends on the possibility of shifting of the tax incidence. In analysing the impact of tax on employment rate and growth, it is essential therefore to analyse tax incidence. It depends on the elasticity of supply and demand in labour market, as well as on other factors that determine flexibility of wages (e.g. negotiating skills of unions, minimum wage etc.).

Thus, for example, in markets where negotiating skills of unions are not strong, or where labour supply is not flexible to change of wages, an entrepreneur will be able to shift taxes on the worker, which will result in a lower net wage and the same gross cost of labour for the employer. In a real situation, workers will eventually react on reduction of their net wages, i.e. reduction of their income. Are they to offer a higher or lower amount of labour to the market now? If substitution effect prevails, they will offer less labour, expanding their leisure time. If income effect prevails, the workers will want to work more, in order to compensate for the lost income, which will result in a higher amount of labour in the market. This means that workers' reaction on taxes can be to work more or to work less, depending on what will prevail - substitution effect or income effect. Which way the combination works out depends upon preferences. For some preferences labour supply increases with taxation, with others it decreases.

In the context of economic theory, the income effect is the change in an individual's or economy's income and how that change will impact the quantity demanded of a good or service. The relationship between income and the quantity demanded is a positive one, as income increases, so does the quantity of goods and services demanded.

Income effect where a tax is imposed on the labour income as a result the worker will not be able to buy most of the things he wants thus the effect is to persuade him to do more work in order to restore his disposable income to its previous level

Substitution effect describes the relationship between a change in relative prices and any resulting change in a person's expenditure pattern. It describes the effect on a person's choice between work and leisure as the marginal benefit from either or both.

Only empirical research can help finding out which of the effects prevails in a given market, that is, will introduction of taxes and reduction of real net wage encourage people to offer more or less labour. In markets where negotiating skills of unions are strong and where labour supply is flexible to changes of wage, an entrepreneur will not be able to shift taxes on workers. The workers will react to introduction of taxes with demands for increased net wages. This will make the cost of labour higher for the entrepreneur and he will reduce the demand for labour. Such reduced demand for labour results in reduced employment rate and, with constant use of capital, could lead to lower growth. Empirical research indicates that labour markets are mostly rigid, that is, entrepreneurs bear higher tax burden than. So, when conditions in labour market are rigid, workers will oppose paying labour tax, thus initiating a negotiating process and pressure for wage increase. This will increase the cost of labour for entrepreneurs.

For its part, higher cost of labour for entrepreneurs reduces demand for labour; by changing relative costs of labour and capital, it stimulates capital-intensive production. Thus, reduction of tax burden on labour, as well as reduction of rigidity in a labour market (reviewing the amount of minimum wage; unemployment benefit; increased mobility of labour force) would lead to a higher supply and demand for labour. This would result in increased employment rate on the one hand and increased output on the other hand.

6.4.2 Impact of taxes on consumption on wages and employment

Beside direct taxes, indirect taxes (that is, consumption taxes) also have impact on the supply of labour by reducing the purchasing power of net wage. However, workers seem to be reacting somewhat slower to a change in the consumption taxes, and the impact of the consumption taxes on labour supply also appears within a longer period of time than normally is the case with direct taxes. Taxes on labour income and consumption spending encourage households to shift away from work in the legal market sector and toward untaxed uses of time such as leisure, household production, and work in the shadow economy. Empirical evidence also show that taxes affect work activity directly through labour supply-and- demand channels and indirectly through government spending responses to available tax revenues. Higher tax rates on labour income and consumption expenditures lead to less work time in the legal market sector, more time working in the household sector, a larger underground economy, and smaller shares of national output and employment in industries that rely heavily on low-wage, low -skill labour inputs.

6.5 Effects of Taxation on Production, Consumption and Distribution

6.5.1 Effects on Production:

a) Production is affected by taxes in two ways:
   - By affecting the ability to work, save and invest
   - By affecting the desire to work, save and invest

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b) A tax on necessaries of life will obviously affect the workers productivity and hence reduce production. A heavy tax on income tends to reduce the ability to save and invest on part of individuals. A decrease in investment is bound to affect adversely the level of output in the country
c) Normally taxation induces people to work harder, earn more, save more and invest more to increase their income and enjoy the same income after tax
d) Some taxes has no adverse effects, for e.g., import duties, tax on monopolists, etc.
e) High marginal rates of income tax are likely to affect adversely the tax payers desire to work, save and invest
f) The reaction varies from individual to individual. It depends on the individuals elasticity of demand for income. When it is fairly elastic, the tax will lessen his desire to work and save
g) Entrepreneurs may avoid the production of goods which are taxed. There is likely to be a diversion of resources from some sectors of economy to others

6.5.2 Effects on Income Distribution:

a) The effects of taxes on income distribution depends on the type of taxes and rates of taxes
b) Taxation of goods of mass consumption is regressive and redistributes incomes in favour of rich.
c) But if such commodities are exempted and luxuries are taxed, and the taxation is made progressive, then the income will be redistributed in favour of poor.

6.5.3 Effects on Consumption:

a) By imposing tax on a consumable good which is injurious to health, its consumption can be checked.
b) Similarly the tax on luxury goods can decrease their consumption and resources diverted to the production of mass consumption

7. Incidence of Taxation

One of the important concepts of taxation is the incidence of tax. Taxes are not always borne by the person who pays the tax; in many instances the burden of tax is shifted to another person. Tax incidence is said to be on the person who ultimately bears the burden of tax whereas impact of tax is on the person from whom government collects money in the first instance. It is important for the government to know who ultimately bears the tax in order to achieve equality in taxation.

7.1 Statutory and economic incidence

It is usual to distinguish between statutory / legal and economic incidence.

The statutory / legal incidence refers to the person on whom the law says the tax obligation falls. Legal incidence is established by law when new taxes are enacted, and specifies which individuals or companies must physically remit tax payments to the revenue authorities.

7.2 Absolute incidence and differential incidence of tax

The distributional impact of tax or systems of taxes depends partly on how the question is framed.

An **absolute incidence** examines the effects of a tax when there is no change in either other taxes or government expenditure. The examination considers the burden of change in taxes without regard to the use the tax proceeds. However, the true burden of the tax cannot be properly assessed without knowing the use of the tax revenues. If the tax revenues are employed in a manner that benefits owners more than producers and consumers then the burden of tax will fall on producers and consumers. If the proceeds of the tax are used in a way that benefits producers and consumers, then owners will suffer the tax burden.

A **differential incidence** examines how incidence differs when one tax is replaced with another, holding the government budget constant. The differential incidence analysis carries out a revenue-neutral change in tax by raising one tax while lowering another.

7.3 Shift ability of Incidence of taxation

Burden of tax may be shifted from one person to another; shifting finally ends in incidence. A person on whom tax is levied may shift the burden of tax on another person either entirely or partly or he may not be able to pass on the burden at all.

Types of incidence shifting

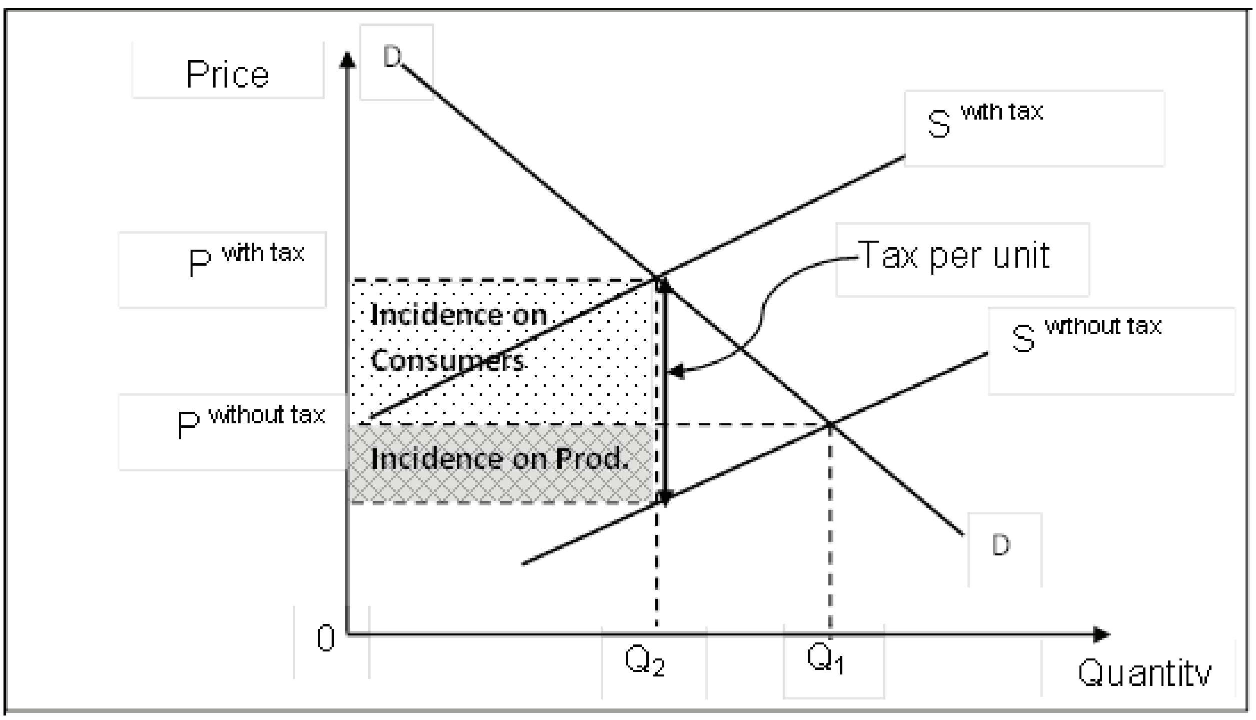
- Forward shifting of tax takes place if burden of tax falls entirely on user and not on the manufacturer/supplier of the goods or service;
- Backward shifting occurs when the price of the product/ service remains same but the cost of tax is borne by the manufacturer.
- In certain cases, there would be no shifting of tax at all.

Factors determining shift ability of Incidence of taxation

It would appear that the incidence of a tax or where its ultimate burden rest, depends on a number of factors. We give below some of them in a summary way.

(a) Elasticity:

While considering incidence we consider both elasticity of demand and elasticity of supply. If the demand for the commodity taxed is elastic, the tax will tend to be shifted to the producer but in case of inelastic demand, it will be largely borne by the consumer. In case of elastic supply, the burden will tend to be on the purchaser and in the case of inelastic supply on the producer.



$P_s = P_d - t$

$\Delta P_s = \Delta P_d - \Delta t$

At equilibrium $Q_d = Q_s$. *Therefore we can convert this into a relationship between percentage changes*

$$\frac{\Delta Q_d}{Q_d} = \frac{\Delta Q_s}{Q_s}$$

$$\text{Recall } \eta = \frac{\Delta Q}{\Delta P} x \frac{P}{Q}$$

$$\frac{\Delta P_d}{P_d} \bullet \eta_d = \frac{\Delta P_s}{P_s} \bullet \eta_s$$

$$\therefore \frac{\Delta P_d}{P_d} \bullet \eta_d = \frac{\Delta P_d - \Delta t}{P_s} \bullet \eta_s$$

More simplifications will yield

$$\frac{\Delta P_d}{\Delta t} = \frac{\eta_s}{\eta_s - \eta_d} = I_d$$

- ✓ If supply elasticity η_s is zero (very inelastic supply), $\mathbf{I_d}$ is zero; consumers bear none of the tax incidence.
- ✓ If supply elasticity η_s is ∞ (very elastic supply), $\mathbf{I_d}$ is one; consumers bear the entire tax incidence.
- ✓ If demand elasticity η_d is zero (very inelastic demand), $\mathbf{I_d}$ is one; consumers bear the entire tax incidence.
- ✓ If demand elasticity η_d is ∞ (very elastic demand), $\mathbf{I_d}$ is zero; consumers bear none of the tax incidence.

The above incidences are extreme cases. Most markets fall between two extremes, and ultimately the incidence of tax is shared between producers and consumers in varying proportions.

- ✓ $\mathbf{I_d}$ is sometimes called the pass-through fraction for buyers, and is expressed in percentage of the tax incidence borne by buyers.

Example:

If elasticity of demand is -0.4 and elasticity of supply is 0.5, the pass-through to buyers is calculated as 0.5/[0.5-(-0.4)] = 0.5/0.9 = 56%. This means 56% of any tax will be paid by the buyers and 44% by the producers

(b) Price: Since shifting of the tax burden can only take place through a change in price, price is a very important factor. If the tax leaves the price unchanged, the tax does not shift.

(c) Time: In short run, the producer cannot make any adjustment in plant and equipment. If, therefore, demand falls on account of price rise resulting from the tax, he may not be able to reduce supply and may have to bear the tax to some extent. In the long run, however, full adjustment can be made and tax shifted to the consumer.

(d) **Cost:** Tax raises the price; rise in price reduces demand and reduced demand results in the reduction of output. A change in the scale of production affects cost and the effect will vary according as the industry is decreasing, increasing or constant costs industry. For instance, if the industry is subject to decreasing cost, a reduction in the scale of production will raise the cost and hence price, shifting the burden of the tax to the consumer.

(e) **Nature of tax:** The incidence of taxation will definitely depend on the nature of tax. For example, an indirect tax burden is fall on the consumer.

(f) **Market form:** Another factor determining the incidence of taxation is the market form. Under perfect competition, no single producer or single purchaser can affect the price; hence shifting of tax in either direction is out of the question. But under monopoly, a producer is in a position to influence price and hence shift the tax.

Theories of Tax Shifting and Incidence

a) **Concentration or Surplus theory**:
According to concentration theory, each tax tends to concentrate on a particular class of people who happen to enjoy surplus from their products.

b) **Diversion or Diffusion theory**
The diffusion theory states that the tax eventually got diffused in the entire society. That is, the final placing of tax is not one but multiple. The process of diffusion took place through shifting or through process of exchange.

c) **Modern Theory:**
According to modern theory, the concentration and diffusion theories are partially true. Actually there are both concentration and diffusion of taxes according to the conditions present. The modern theory seeks to analyse the conditions which bring about concentration or diffusion.

8. The Concept of Tax Buoyancy And Elasticity And Taxable Capacity

8.1 Tax buoyancy and elasticity

(i) Tax Buoyancy

There is a strong connection between the government's tax revenue earnings and economic growth. The simple fact is that as the economy achieves faster growth, the tax revenue of the government also goes up. Tax buoyancy explains this relationship between the changes in government's tax revenue growth and the changes in GDP. It refers to the responsiveness of tax revenue growth to changes in GDP. When a tax is buoyant, its revenue increases without increasing the tax rate.

Example

In a particular year, country A GDP growth rate was nearly 9 per cent. The tax revenue of the government, especially, that of direct taxes registered a growth rate of 45 per cent in the same year. We can say that the tax buoyancy was five (45/9). In the following year, the financial crisis occurred. The GDP growth came down to six percent. Tax revenue growth also fell steeply; to 18 per cent. This means tax buoyancy was 3 for the year. We can imagine that had the GDP growth came down further in the following year, to say 4 per cent, tax revenue growth would have fell to 8 per cent; indicating a tax buoyancy of 2.

Tax buoyancy, however, is a crude measure which does not distinguish between discretionary and automatic growth of revenue. Tax buoyancy measures the total response of tax revenues to changes in national income. It takes into account both the effect of increases in GDP and discretionary changes on the revenues from a tax. Discretionary tax changes are under the control of tax authorities. They are due to changes in tax rates, base definition, and collection and enforcement procedures. Non-discretionary changes arise from the natural growth of economy.

Tip
Tax buoyancy = change in tax revenue in response to one unit change in tax base/GDP

Higher Tax Buoyancy (More than 1)

- Tax Revenue rises faster than the economic growth
- As economy grows, the Government can expand its activities OR reduce tax rates

Low Tax Buoyancy (Less than 1)

- Tax Revenue rises slower than the economic growth

(ii) As economy grows, the Government will need to cut down its activities OR increase tax rates

Tax Elasticity

A similar concept to Tax Buoyancy is tax elasticity. Tax elasticity, unlike tax buoyancy, tax elasticity excludes the impact of discretionary effects (e.g. impact of changes in tax rates and tax bases) on the increase of tax revenue. It measures the pure response of tax revenues to changes in the national income. It reflects only the built-in responsiveness of tax revenue to movement in national income/GDP. The value of the tax elasticity gives an indication to policy-makers of whether tax revenues will rise at the same pace as the national income.

Suppose that in 2017 the tax on soda was TZS 200/liter and 8 million liters were sold, yielding a revenue of TZS 1,600million. In 2018 the tax is raised to TZS 240/liter and 8.1million liters are sold, for a revenue of TZS 1,944million. Inflation is running at 15% annually and real GDP is rising by 2.5%. Calculate the buoyancy and elasticity of the soda tax.

Tax buoyancy

Revenue in 2017: TZS 1,600million.

Revenue in 2018 adjusted for inflation: 1944/1.15 = 1690.

So increase in real revenue is 5.625% (90/1600)

Since real GDP rose by 2.5% during the same period, tax buoyancy is 2.25 (5.625%/2.5%).

Tax elasticity

The increase in tax revenue is due both to higher sales of soda (i.e. more liters sold – a reflection of increased GDP) as well as change in the tax law (i.e. change in tax rate).

To determine tax elasticity we ask: What would have happened to tax revenue if the tax rate of 2017 (i.e. TZS 200/liter) had not been changed (to TZS 240/liter)?

Presumably the tax revenue in 2018 would have been 1,620m (200x8.1m) in nominal values. The real value (adjusted for inflation) is 1,409m (=1620/1.15),

The revenue has declined by 11.9%.

The tax elasticity would therefore be -4.76 (= -11.9/2.5).

This indicates that if the tax rate had not been changed, then real revenue would have fallen between 2017 and 2018, despite the increase in GDP.

8.2 The concept Taxable capacity

Taxable capacity refers to maximum capacity of a community to pay taxes or the maximum limit up to which people can normally pay taxes. It is the ability of the tax payer to pay the tax assessed to him/her and the same time retain a reasonable level of income to enable him/her to live the life he/she is accustomed. i.e. ability of a nation to obtain from tax payer the revenue necessary from the imposed taxes.

There are two types of taxable capacity

Absolute taxable capacity: means maximum amount or proportion of national income that can be taken by the Government in form of taxes without producing disagreeable (unpleasant) effects.

Relative taxable capacity: This is a comparative term. Is the ratio of the taxable capacity of one unit to that of the other unit. Through it, the taxable capacity of two countries or two individuals can be compared.

Measurement of taxable capacity

The taxable capacity represents the average or normal share of income that can be collected in the country

Taxable capacity = (Estimated Tax revenue/ (GDP/national income)

Taxable capacity and tax effort

Tax capacity is the maximum level of tax revenue that a country can achieve and tax effort—the ratio between actual revenue and tax capacity

Tax effort is the actual tax yield of a country relative to the tax capacity of the country.

- Tax effort = (Actual T/Y)/(Tax capacity T/Y)
- If tax effort > (or <) 1, then country is collecting more (or less) than the average tax yield for countries with similar characteristics
- Tax effort is affected by both tax structure (tax rates, bases, etc) and tax administration and compliance. Tax effort can be increased by increasing tax rates, expanding tax bases, improving tax enforcement and compliance, etc

The following are determinants of the nation’s taxable capacity:

(i) **The size of population:** Taxable capacity is very much affected by the increase in national income and by the rate of growth in population. If the increase in national income is greater than the growth in population, the per capita income goes up. The taxable capacity of the individuals rises. If the rate of growth of population is higher than the national income, the taxable capacity decreases.

(ii) **The distribution of national income:** Taxable capacity is also influenced by the distribution of national income within a country. If there is unequal distribution of wealth in the country, the taxable capacity of the nation will be high, but if the income is equally distributed, then the taxable capacity will be low. A man earning an income of Tsh. 50,000 a month is able to pay more to the government than thirty persons earning Tsh. 300 per month.

(iii) **Character of taxation:** If taxes are planned wisely, then they give less bitterness from people and bring forth a large yield, the taxable capacity will be at high level.

(iv) **Purpose of taxation:** Purpose of taxation has a direct bearing on taxable capacity of a nation. I citizens of a country are satisfied with purpose of taxation i.e., the increase in welfare of people, then they show greater willingness to pay taxes to government. Whereas, if they find that revenue will be spent for unproductive purposes, they hesitate to pay taxes.

We conclude, therefore, that if state spends revenue for purposes such as education, sanitation, fighting for famine, diseases, etc. then taxable capacity shrinks.

(v) **Psychological factor:** Psychological factor, is a very important factor in determining taxable capacity of a nation. If people are satisfied that government is doing its utmost to raise standard of living of the masses and in maintaining prestige of the country, then they try to sacrifice their lives what to say of money for the government. A simple approach to patriotism (nationalism or loyalty) brings forth (out or forward) tons of gold.

(vi) **Standard of living of people:** If standard of living of people is high, they work more efficiently so that they may enjoy a still better standard of living. When they work enthusiastically (actively), they receive higher wages from their employers. Taxable capacity tends to increase then.

(vii) **Effect of inflation:** If a country is in grip of inflation, purchasing power of people is reduced, taxable capacity of nation shrinks considerably. But if value of money is high and country is not faced with unemployment, then taxable capacity of people is quite high.

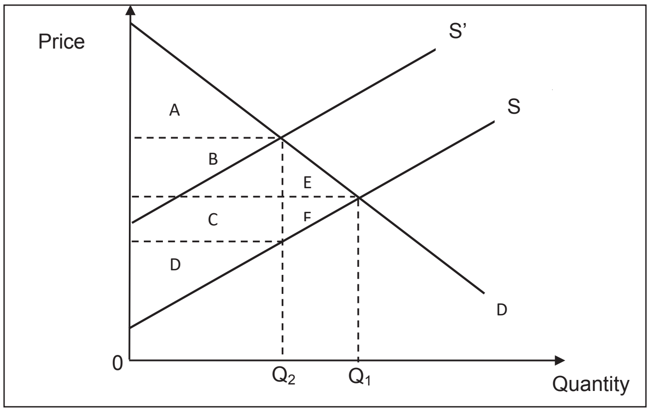
Explain the concept of excess burden and optimal taxation, explain the relation between tax rate and revenue collection, explain the concepts tax incentives and tax competition

[Learning Outcome I, j, k]

9. The Concept of Excess Burden and Optimal Taxation

9.1 Excess burden

Excess burden or DWL of taxation, also known as distortionary cost of taxation, is the economic loss that societies suffers as the result of the tax, over and above the revenue it collects.



After Tax
Consumer Surplus = A
Producer Surplus = D
Aggregate surplus = B + C + E + F
Tax Revenue = B + C
Deadweight loss = E + F

Deadweight loss can be calculated as: DWL = ½ x T x (Q_1 – Q_2)

9.2 Optimal taxation

Tax system is said to be optimal if it attain the goals of revenue collection with a minimum possible distortions in the economy. The level of distortion is measured by using excess burden. So a tax system that minimizes excess burden and yet achieve the revenue collection goals is optimal. The optimal taxation theory thus seeks to answer a crucial tax policy question, "at what rates should various goods and services be taxed to raise target revenue with minimum possible excess burden

The Ramsey Rule

i. Imagine that a government wants to raise a given amount of revenue with the minimum dead weight loss. How must this be done? The philosopher Frank Ramsey worked out the answer - now known as the "Ramsey rule" - in the 1920's.

ii. Given proportional taxation, linear (and independent) demand, and constant MC of production, the Ramsey rule tells us to set tax rates *inversely proportional to demand elasticity's*. The more elastic the good, the less it is taxed.

   If the elasticity of corn is .3, and the elasticity of grapes is .6, the Ramsey rule tells us to set the tax rate on corn equal to twice the tax rate on grapes.

iii. Under these assumptions, all quantities consumed fall by *equal* fractions.

iv. There is an enormous literature that relaxes the preceding assumptions in predictable ways. Ramsey's intuition is quite robust.

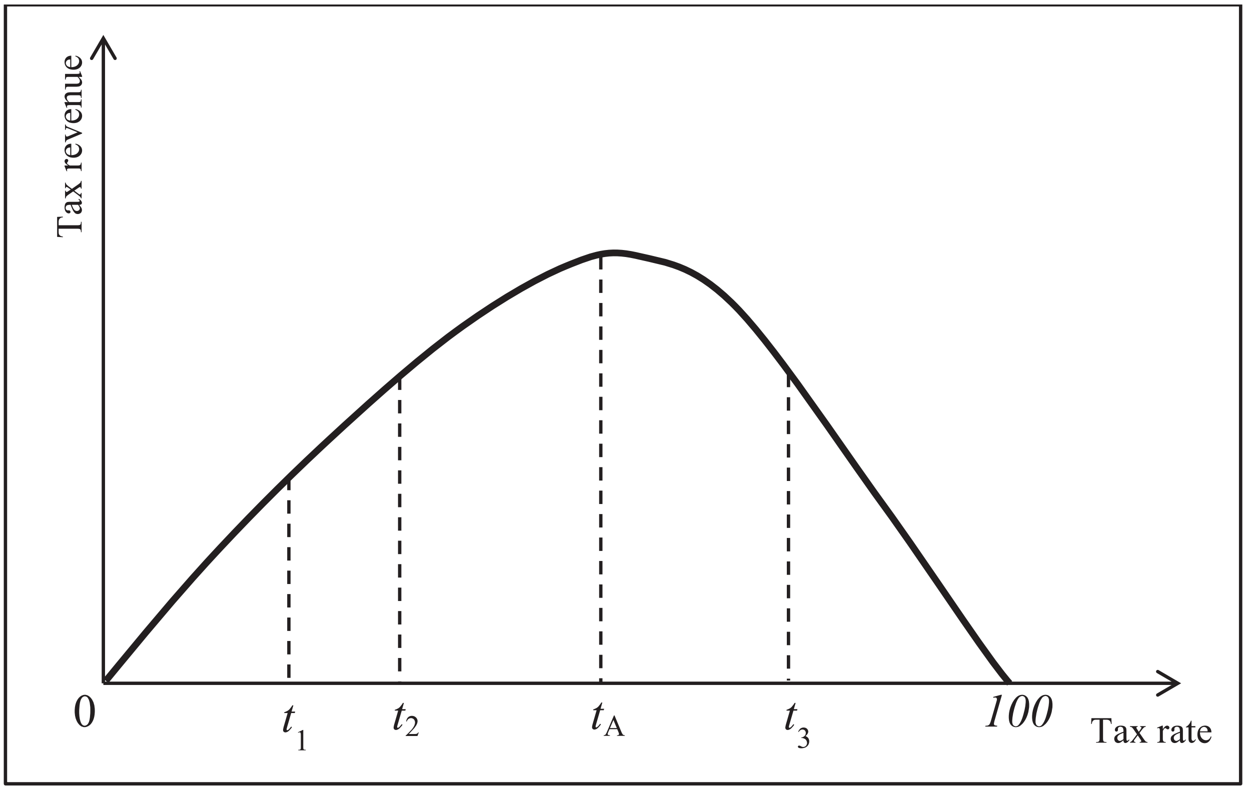
v. If there is a fixed cost of taxing an item at all, DW loss minimization is likely to prescribe an exclusive focus on low-elasticity items.

10. The Relation Between Tax Rate and Revenue Collection

A tax on any kind of spending has two effects: it raises price and reduces the quantity. In raising price, the tax will increase revenue, but in reducing quantity, or eroding the tax base, it will reduce revenue. The same kind of tradeoff occurs with taxes on incomes or on assets. With this revenue increase and base erosion tradeoff, is there a point at which at which base erosion dominates and hence reduce tax collection? Professor Arthur Laffer [1979] demonstrate using diagram, this kind of complementarity between tax rate and revenue collection. The diagram is known as Laffer curve, named after his name.

The Laffer curve assumes a parabolic shape, whereas as tax rate increase revenue will increase up to a point where further increase in tax rate will reduce revenue collection Though there is no much empirical evidence as to what tax rate causes revenue backward, but a Laffer curve idea offers a useful caution when designing a tax system. As the tax rate increase people will have more and more incentives to evade taxes hence erode the tax base. Increased tax rates are directly linked to increased excess burden, deadweight losses, at an increasing rate.

Laffer curve



11. The Concepts Tax Incentives and Tax Competition

11.1 Tax Incentives

A tax incentive is defined as ‘a deduction, exclusion or exemption from a tax liability, offered as an inducement to engage in a specified activity such as investment in capital goods for a certain period’. Tax incentives are granted to attract FDI and/or to promote specific economic policies, such as to encourage investment in certain sectors

Arguments for:

- Substantial increase in the level of investment and economic activity.
- Taxes are an important impediment to invest since they reduce retained earnings and increase product or prices.
- Incentives may make unpromising investments attractive by permitting a rapid recovery of capital and a higher rate of return.

- They also make available to the taxpayer funds that would not otherwise be at his disposal.
- Tax incentives do publicize and enhance a country's investment climate.

Arguments against:

- They reduce government revenue.
- Bring inequity as they cause differentials in tax burden.
- Different burdens upon tax administration.
- Increase compliance costs.

11.2 Tax Competition

– It refers to the competition between countries which compete for investment by lowering the tax rates on business, or offering other tax advantages, in order to attract or keep companies located within them.

Argument for tax competition
Proponents of tax incentives often argue that lower tax burdens give investors a higher net rate of return and therefore free up additional income for re-investment. The host country thus attracts increased FDI, raises its income and also benefits from the transfer of technology.

Argument against tax competition
(i) Result in a loss of current and future tax revenue
(ii) Create differences in effective tax rates and thus distortions between activities that are subsidised and those that are not
(iii) Could require large administrative resources
(iv) Could attract mainly footloose firms
(v) Can be outside the budget and non-transparent

Self-Examination Questions

Question 1
Explain the distortionary effects of personal income tax and corporate income tax.

Question 2
(a) "Elasticity of demand and supply is an important determinant of the effects of taxation in the economy". Discuss.
(b) Briefly explain the extent to which taxes can be used to counteract inflationary pressures.

Question 3
In light of inflationary tendency in the economy, illustrate how effects of taxation on inflation are dependent on the concept of elasticity.

Question 4
(a) Explain in detail the concept of incidence of taxation.
(b) A tax of two percent is charged on every onion produced by a farmer in Tanzania.
REQUIRED:
Explain in what circumstances the farmer will be able to pass on the entire tax to the consumers.

Question 5
Taxation traces its origin to the ancient times as a major source of revenue needed for governance. Kingdoms, monarchies, and even dynasties had an elaborate form of taxation imposed on their subjects to source funds that were used to run affairs of the government.

Taxation has had a long and influential history in the shaping of civilizations throughout the World. All the great ancient civilizations such as Egyptian, Romans, Greek, Persians, Zulu, Oyo, Malian, Songhai, and Benin, taxed their people to achieve a collective greatness. The above sources of revenue also apply to Tanzanian Tax system.

Required:

(a) Evaluate the requirements of a good tax system.

(b) Explain the effect of taxes on savings.

Question 6

(a) One of the desirable characteristics of a good tax system is fiscal neutrality.

Required:

(i) Explain briefly the meaning of this characteristic.

(ii) What is the underlying assumption guiding this characteristic?

(b) Traditionally, economists argue against indirect taxes and in favour of direct taxes on grounds that the former distorts consumer preferences between taxed goods and other goods.

Required:

Comment on the above statement, highlighting the role that elasticity of demand **may** play on such distortion.

Question 7

a) Identify two differences between the economic purpose and social purpose of taxation

b) Explain three advantages of indirect taxes as compared to direct taxes.

c) Explain any two cannons of taxation

Question 8

(a) Comment on the following statement: Taxation under the 'benefits theory' operates on the similar lines as prices function in a free market.

(b) Briefly explain the sacrifice theory and discuss its relationship with the ability to pay theory

Question 9

(a) Briefly explain the benefit theory of taxation.

(b) How does the ability-to-pay principle of taxation differ from the benefit principle? What problems are encountered in implementing both these tax philosophies?

(c) In the ability to pay approach, what should be the sacrifice of each taxpayer and how should it be measured?

Question 10

(a) What is the difference between impact of tax and incidence of tax?

(b) Explain the concepts of statutory incidence and economic incidence.

(c) Explain the incidence of taxes in a competitive market.

Question 11

(a) Explain the meaning of consumer surplus and producer surplus.

(b) Briefly explain the effects of taxation on savings of individuals

(c) Briefly explain on the term "tax wedge"

(d) Explain the income and substitution effect

Question 12

(a) Briefly, define 'taxable capacity'.

(b) Discuss briefly factors which may affect a taxable capacity of a country.

(c) Differentiate between 'tax buoyancy' and 'tax elasticity'.

Question 13

(a) Explain the classification of taxes based on how they are levied.

(b) Explain the principle of economy of taxation

Question 14

In efforts to reduce alcohol consumption, the government is considering an introduction of Tshs 15 tax on each gallon (Q) of liquor sold. Suppose that:

- Demand function : PD=100-2Q
- Supply function : PS =10+Q

Required

(i) Calculate equilibrium quantity and price before taxation

(ii) Compute the price paid by consumer, the price received by producer and the quantity sold after taxation

(iii) Calculate the consumer surplus and producer surplus before taxation and after taxation

(iv) Calculate tax revenue to the government and Dead Weight Loss (DWL)

(v) Calculate price elasticity of demand and price elasticity of supply

(vi) Calculate the share of tax revenue paid by consumer and share paid by producer.

(vii) Who pays more tax and why?

Question 15

It is a common practice for government revenue authorities in different countries to change tax rates or introduce new taxes in both direct and indirect taxes.

Required:

Discuss the implication of changes in taxes on each of the following:

(a) Demand and supply of goods and services.

(b) Savings of individuals and companies.

(c) Producer and consumer surplus.

(d) Tax impact on consumption on wages and employment.

Question 16

(a) Briefly evaluate the 'Sacrifice Theory' and discuss its relationship with the 'Ability to Pay Theory'.

(b) Illustrate the key differences between the 'Benefit Theory' on one hand and the 'Sacrifice and Ability to Pay Theories' on other hand.

Question 17

The use of investment tax incentives in developing countries has been very popular and very controversial for decades. Despite the controversy, many countries around the world offer investment tax incentives of one form or another.

Required:

(i) Describe the essential features of investment tax incentives

(ii) Discuss six (6) fundamental premises that underpin the use of investment tax incentives in developing countries

(iii) What would be your arguments if you were to advise against tax incentives? (any eight arguments)

Question 18

There is an emerging consensus that tax base erosion due to tax incentives in developing countries is compounded by the lack of transparency and clarity of provision, administration, and governance of tax incentives.

Required:

Give five (5) advises in line with best practices as to what measures the government might implement to promote governance of tax incentives.

Question 19
Tax exemptions aimed at Foreign Direct Investment, (FDI) are especially important form of tax expenditure in low income developing countries category and, in many cases, significantly undermining their tax revenue base. The incentives for multinationals to negotiate tax breaks with developing countries frequently results in a "race to the bottom" in which countries in this category are made collectively worse off, to the benefit of the multinational investors. As such, fiscal incentive based competition strategy to attract FDI continues to be a subject of debate.
Required:
Critically appraise this statement in the light of current tax exemption practices in Tanzania.

Answers to Self-Examination Questions

Answer to SEQ 1
The distortionary effects of the Personal Income Tax and corporate income tax are as follows:

(i) **Effects on labour supply.** The income tax alters labour; the leisure trade-off; based on the income and substitution effects we can see that the substitution effect is negative in that it reduces hours worked. On the other hand, the income effect may be positive or negative. In that regard, the net effect is an empirical matter. It should be noted also that, quantitative impact is likely to vary across individuals in different circumstances. Hours worked by most working-age men are relatively insensitive to income tax especially when most work on full-time basis. On the other hand, married women would be more responsive since it could be easier to vary part-time hours.

(ii) **Effect on Saving.** With regard to income and substitution effects, an overall impact of income tax on saving is ambiguous. The taxation of interest on savings for instance without corresponding subsidy to interest paid on borrowings leads to a kink in the budget line for the allocation of resources between present and future consumption. The income tax systems vary in terms of relative taxation of earned income and unearned income on interest and dividends. As it is clear that Tax Base would be Income minus Net Saving whereas the effect would be to tax income when spent, not when earned.

(iii) Taxes reduce the income that the person has available to purchase goods and services.

(iv) Taxes reduce business output by raising prices (cost).

Answer to SEQ 2

(a) In their discussion, candidates are expected to include the following points which (may) justify that the effects of taxation in the economy depend on the elasticity of demand and supply. The discussion focuses on 'allocative' and 'distributive' effects of indirect taxation.
Effects of taxation (on resourced allocation, distribution and inflationary tendency) depend on elasticity as follows:

- Given the elasticity of supply, the effect on demand for a good will be directly related to its demand elasticity;
- Goods with higher elasticity of demand would be affected more and those with lower elasticity of demand would be affected less by a given tax rate;
- Similarly, a good with a higher elasticity of supply would be affected more by tax on it than a good with a lower elasticity of supply;
- It follows, therefore, the extent to which a given tax on a commodity would reduce its output and release resources for other industries would depend upon its elasticity of demand;
- Consequently, it is necessary we consider the relevant elasticity of demand and supply of a good while using an indirect tax to shift its production and resource appropriation.

OR

Alternative explanations (answer)

Candidates may *alternatively* discuss the following points:

- Goods having a high elasticity of demand and a low elasticity of supply are not likely to show much inflationary tendencies;

- When indirect taxes are imposed on the cost of production of the goods having high elasticity of demand and low elasticity of supply, a greater part of their incidence gets settled on the suppliers themselves;
  - This reduces their profits and has an effect of checking inflation.

- Inflationary price rise is mainly the case of those goods which have a low elasticity of demand and high elasticity of supply

  - If indirect taxes are imposed on such goods, their incidence will be shifted on the buyer;
  - This feeds the forces of inflation;
  - If taxed goods are of consumption variety:

    - ▹ Will raise the cost of living and will force the workers to demand higher wages;
    - ▹ Then, due to wage rise, cost of production in industries producing even untaxed goods will go up.

- Therefore, rational choice should be made on commodities to be taxed and at what rates of taxation

  - E.g. luxuries may be taxed but not necessities (basic goods), which will raise the cost of production all over;
  - If necessities are to be taxed, then the rates should be quite low.

(b) Extent to which taxes can be used counteract inflationary pressures. Candidates are expected to construct their arguments around the following two rationales:

- Taxes as built-in-stabilizer
- Belief that taxes can be used to curb prices and demand.

The above two arguments can be further explained as follows:

- Taxes do act to some extent as built in stabilizers;
- Given the level of government expenditure, the tax system itself tends to create a budgetary surplus during a boom and a deficit during a depression;
- The created budgetary surplus would curb expenditure and demand while a budgetary deficit created would have the opposite effect and thus an anti-cyclical pressure is generated;
- This happens because revenue from direct and indirect taxes is dependent upon the level of economic activities
- Also due to the fact that direct taxes are progressive.

Answer to SEQ 3

Effects of taxation on inflationary tendency depend on elasticity as follows:

- Goods having a high elastic of demand and a low elasticity of supply are not likely to show much inflationary tendency.
  - Therefore, when indirect taxes are imposed on the cost of production of the goods with these elasticity characteristics, a greater part of their incidences get settled on the suppliers themselves.
  - This reduces profits and has an effect of checking inflation

- In contrast, inflationary price rise is mainly the case of those goods which have a low elasticity of demand and high elasticity of supply
    - If indirect taxes are imposed on such goods, their incidence will be shifted to the buyer.
- This feeds the forces of inflation.

If the goods on which indirect taxes are imposed are of consumption variety:

- Will raise the cost of living and will force the workers to demand higher wages.
- Then, due to wage rise, cost of production in industries producing even un-taxed goods will go up.
    - Therefore, judicious choice should be made on commodities to be taxed and at what rates of taxation.
- Thus, luxuries may be taxed but not necessities, which will raise the cost of production all around.
- If necessities are to be taxed, then the rate should be quite low.

Answer to SEQ 4

(c) One of the important concepts of taxation is the incidence of tax. Taxes are not always borne by the person who pays the tax; in many instances the burned of tax is shifted to another person. Tax incidence s said to be on the person who ultimately bears the burden of tax whereas impact of tax is on the person from whom government collects money in the first instance. Burden of tax may be shifted from one person to another; shifting finally ends in incidence. A person on who tax is levied may shift the burden of tax on another person either entirely or partly or he may not be able to pass on the burden at all. One of the factors determine tax incidence is the price elasticity of demand and supply. Prices elasticity of demand is the responsiveness of the quantity demanded of a good or service to a change in its price or in other words it is the percentage change in quantity demanded to a one percentage change in price. Price elasticity of supply us the responsiveness of the quantity supplied of a good or service to a change in its price.

(d) The farmer will be able to pass on the entire burden of tax on the consumers if the product is price inelastic (that means if the price is increased, there would only be a small loss in demand that will be compensated by the additional revenue by increase in price). In case the price of the product inelastic, the farmer may be able to shift the burden of tax only partly on the consumer or may not be able to shift at all.

Answer to SEQ 5

(a)

- The tax collected should be enough to meet public spending needs and contribute to fiscal stability.
- The tax burden should be distributed fairly among actual or potential taxpayers.
- A good tax policy should consider minimizing the potential adverse economic costs of taxation.

(b) **Impact of Taxes on Savings of Individuals**

- Wealthy individuals save more than poor citizens, so it is expected that the taxes collected from higher tax brackets create more burden on savings than the ones collected from lower tax brackets.
- Consequently, a more progressive income tax seems to be creating a heavier burden on savings than a less progressive tax system.
- This claim suggests that a less progressive income tax system would be favorable to the increase in savings of individuals.

Impact of Tax on Gross Savings of Companies

- If profit taxation law allows accelerated depreciation, then depreciation reserves and company savings will increase in the first years following the purchase of fixed assets.
- Profit is divided in the dividends distributed to company owners and undistributed profit remaining in the company.
- Higher taxation of the retained profit will stimulate its distribution to dividends, while lower taxation of the retained profit will increase the company's savings.

Answer to SEQ 6

a) Fiscal neutrality
   i. Fiscal neutrality argues that taxes must not alter the choices and preferences of the members of society
   ii. Assumptions underlying fiscal neutrality is that market mechanisms allocate resources efficiently.

b) Indirect taxes are taxes on specific commodity thus when charged it may raise the price of commodity. Therefore, according to the laws of demand and supply the consumer preferences (demand) for the taxed commodity will decline (distorted). The extent of distortion of consumer preferences will depend on the elasticity of demand of the commodities. Largest distortion will occur when the commodity has perfect elastic demand and there will be no distortion where elasticity of demand is zero (completely inelastic demand) .

c) Direct taxes on the other hand are not tax on specific commodity. Therefore, when the tax is charged it does not affect the price of product and thus consumer preferences will not be distorted.

Answer to SEQ 7

(a)

Economic purpose of	**Social purpose of taxation**
Taxes are used to promote goals such as full employment, satisfactory rates of economic growth, and stability of the money supply.	Taxes are used to reduce the gap between poor and rich. Taxes are therefore used as a redistribution of wealth.
Tax revenues are important because of governments need to manage the economy, regulate society, develop society and provide public goods.	In addition to taxing the rich more than the poor government can use cash transfer system to reduce poverty and promote social equality.

(b) The advantages of indirect taxes in comparison to direct taxes are as follows:

Indirect tax is convenient to both the Government and the taxpayer. It is convenient to taxpayer as the taxpayer do not feel the burden much because they do not pay a lump sum amount for tax and that tax is paid only when making purchases. Moreover, the tax is "price-coated" i.e it is wrapped in price and therefore the burden cannot be easily felt. It is convenient to the Government as well because the business owners collects the tax on the Government's behalf when they charge a price.

There is mass participation. Each and every person getting goods or services has to pay tax. Indirect taxes are the only means of reaching the poor who are always exempted from paying direct taxes. It is a sound principle that every individual should pay something, however little, to the Government.

Unlike direct taxes, the indirect taxes have a wide coverage. Majority of the products or services are subject to indirect taxes. The consumers or users of such products and services have to pay them.

(c) Two canons of taxation are as follows:

(i) **Canon of elasticity**

An ideal system of taxation should consist of those types of taxes that can easily be adjusted. This means that taxation must have built-in flexibility. Taxes, which can be increased or decreased, according to the demand of the revenue, are considered ideal for the system. An example of such a tax is the income tax, which is considered very much ideal in accordance with the canon of elasticity. Taxation should be elastic in nature in the sense that more revenue is automatically fetched when income of the people rises.

(ii) **Administrative efficiency and simplicity**

The collection and disbursement of taxes should take place with the lowest possible cost, e.g. tax revenue must be collected in an efficient way. Efficiency is concerned with neutrality, compliance and administrative efficiency. Taxes should be levied in an economical manner that spurs a country's economic development. Furthermore, compliance of law should be at the lowest possible compliance costs. Compliance costs are cost paid by taxpayers in fulfilling their obligation for keeping records, buying electronic fiscal devices for VAT, paying for financial annual audit or tax preparers etc. The more simple and efficient the tax system is, the 'cheaper' it becomes.

Answer to SEQ 8

(a) The benefit principle is an attempt to establish taxation on a similar basis as market pricing; that is the tax is to be levied in accordance with the benefit received by the individual. It is an attempt to achieve the goal of a neutral tax, one that would leave the economic system approximately as it is, on the free market. It is an attempt to establish a criterion of payment on the basis of benefit rather than sacrifice.

(b) The ability-to-pay approach treats government revenue and expenditures separately. Taxes are based on taxpayers' ability to pay; there is no quid pro quo. Taxes paid are seen as a sacrifice by taxpayers, which raise the issues of what the sacrifice of each taxpayer should be and how it should be measured:

- (i) Equal sacrifice: The total loss of utility as a result of taxation should be equal for all taxpayers (the rich will be taxed more heavily than the poor).
- (ii) Equal proportional sacrifice: The proportional loss of utility as a result of taxation should be equal for all taxpayers.
- (iii) Equal marginal sacrifice: The instantaneous loss of utility (as measured by the derivative of the utility function) as a result of taxation should be equal for all taxpayers. This will entail the least aggregate sacrifice (the total sacrifice will be the least).

Answer to SEQ 9

(a) **Benefit principle**: A principle of taxation in which taxes are based on the benefits received by people using the goods financed with the tax. The benefit principle is often difficult to implement because by their very nature, many government produced goods (public goods) do not have easily measured benefits. But in those cases where benefits are identifiable, government is not shy about establishing taxes, fees, or charges in accordance with the benefit principle. Public college tuition, national park admission fees, and gasoline excise taxes are three common examples. The beneficiaries of education, a wilderness experience, and highway use are asked (required) to pay accordingly.

(b) The benefits received principle of taxation asserts that people and businesses who receive the benefit of a good or service financed by taxes should pay the tax it requires. The ability to pay principle is the opposite of the benefits received principle. It can be difficult for governments to implement the benefits received principle because of its nature. It is not easy to measure the benefits that certain people receive from a public good. Most governments, however, normally implement taxes in cases where benefits are easily identified. Charges, fees and taxes are often levied against those who use public universities, gasoline or national parks. Because the specific people who use these government resources receive much of the benefit from their existence, those people are asked to pay for the benefit they received. As an example, gasoline taxes are often used to construct and repair highways. This is because those who buy gasoline are assumed to be the users and the major beneficiaries of roads and highways. The ability to pay principle is very different from the benefits received principle. The ability to pay principle asserts that the tax burden should be split up according to how able someone is to pay for government services.

(c) The ability-to-pay principle in taxation maintains that taxes should be levied according a taxpayer's ability to pay. This progressive taxation approach places an increased tax burden on individuals, partnerships, companies, corporations, trusts and certain estates with higher incomes. The theory is that individuals who earn more money can afford to pay more in taxes. The sacrifice of each taxpayer and the method of how should it be measured is as follows:

i. **Equal sacrifice***:* The total loss of utility as a result of taxation should be equal for all taxpayers (the rich will be taxed more heavily than the poor).
ii. **Equal proportional sacrifice***:* The proportional loss of utility as a result of taxation should be equal for all taxpayers.
iii. **Equal marginal sacrifice***:* The instantaneous loss of utility (as measured by the derivative of the utility function) as a result of taxation should be equal for all taxpayers. This will entail the least aggregate sacrifice (the total sacrifice will be the least).

Answer to SEQ 10

(a) The impact of tax refers to the way the introduction of taxation, or the raising of tax levels, on a particular product or service, affects the way the product or service is used. The introduction or increase of tax, for example, usually results in the product or service being purchased less often. As a result, the impact of tax, or tax impact, is usually negative for the development of an economy, as it hinders and reduces spending, which is necessary for the growth of an economy. On the other hand, the incidence of tax refers to the people who carry the burden of tax. For example, if you own a large portion of land, but your neighbour owns a small portion of land, and tax on land goes up, you would be said to be part of the population subject to the incidence of tax.

Therefore, a simple way of describing the difference between the impact and the incidence of tax would appear as follows: The incidence of tax relates to the effects upon the people who pay the taxes, while the impact of tax relates to the effects upon the goods and services which are taxed. It could be argued that the two are linked, as if taxes on goods and services are raised, the impact of tax would mean that less people pay for them - as a result, the government and other large bodies have to find a source of income other than VAT, and therefore other taxes may be raised, effecting the incidence of tax

(b) **The statutory / legal incidence** refers to the person on whom the law says the tax obligation falls. Legal incidence is established by law when new taxes are enacted, and specifies which individuals or companies must physically remit tax payments to the revenue authorities.

The statutory incidence of taxes is generally very different from their final economic burden. Taxes, disrupt what otherwise would be an efficiently functioning market by influencing the relative prices facing individuals, they lead to changes in individual behaviour. This disruption is seen as a tax wedge between the demand price and the supply price. Changes in the demand and supply prices after a tax, when compared to the equilibrium price before the tax, is called **incidence or burden of the tax**. The economic tax incidence identifies who ultimately pays the tax.

(c) Tax incidence is concerned with the effect of taxation upon prices and profits. Since perfectly competitive firms earn zero profits, under perfect competition there is only a price effect. Consumer prices increase by just the amount of the tax if the long run supply curve is horizontal, and by less than that if it is upward sloping. Price rising by more than the amount of the tax is not a possibility in this market. It is difficult to shift tax burden in perfect market containing many buyers and sellers, full knowledge, no restrictions on exit and entry as small increase in price lead to significant decrease in sales. In a perfectly competitive partial equilibrium framework, the economic incidence of a tax is unaffected by which side of the market the tax is levied on. Second, the economic burden of a tax is borne more heavily by the side of the market that is less elastic (in absolute value). No more than 100 percent of the tax can be shifted to a party. In the competitive market, if the supply is completely inelastic or if demand is completely elastic or demand is completely inelastic, the tax is entirely borne by consumers.

Answer to SEQ 11

(a) In a market without taxes, **the difference between the market price of a good and the highest amount consumers would be willing and able to pay for it is referred to as consumer surplus**. Consumer surplus occurs because first, every consumer has his own maximum price he would be willing to pay for a good (although the market aggregates this demand, along with supply, to produce a market price); secondly, is due to the fact that demand is rarely perfectly elastic. C**onsumer surplus can be seen as the total use or value that consumers get without paying for it. Producer surplus represents the difference between the market price and the lowest amount for which producers would be willing and able to sell a good in a market without taxation**. It is possible -- and, in fact, normal -- that there will be consumer surplus and producer surplus for the same good. In the same way each consumer has her own maximum price for a good, each producer has a minimum price for the good. In most cases, this is at or slightly above the producer's costs, because there is no benefit to producing and selling more cheaply than this. In effect, **producer surplus means profit.**

(b) **Taxes can reduce economic growth by affecting savings and investment. The higher the proportion of income that is being saved and invested, the higher will be the future income level.** The net savings of individuals, consisting of savings in households and retained earnings of companies, represent the real potential, available for new investments. The major part of these savings is accumulated in households, while the retained earnings account for only a small part of them. If all individuals would save the same proportion of income, then the impact of income tax on the total savings would be the same, regardless of the pattern of the distribution of tax burden to individuals. But, wealthy individuals save more than poor citizens, so it is expected that the taxes collected from higher tax brackets create more burden on savings than the ones collected from lower tax brackets. Consequently, **a more progressive income tax seems to be creating a heavier burden on savings than a less progressive tax system. The propensity to save is affected by non tax factors** like demography i.e. it varies with stage in a life cycle: in youth and in old age it is much lower than in middle age when income is highest and when people save for education of their kids, for a house or a flat and for the old age. Income tax also affects savings by lowering the net return from savings, that is, by lowering the interest rate on savings. Furthermore the savings of individuals are motivated with various other reasons and their final amount does not have to depend on interest rate trends only. Besides income tax, consumption tax also affects savings of individuals. While income tax is generally progressive, consumption taxes are mostly regressive, that is, they are mostly paid by lower-income households. Since these households have a higher marginal propensity to consume than the households with higher income and since their marginal propensity to save is lower than the one of

(c) wealthy individuals, **consumption taxes burden total consumption more and savings less**. This is why it is often recommended to the countries with low level of savings that they should direct their tax systems to taxation of consumption much more, because this will boost savings and growth, too.

(d) Labour taxes drive a wedge between what workers receive and what firms pay, and empirical analysis suggests that employment falls as a result, thereby lowering potential output. The extent of the fall in employment depends on labour-market institutions and the wage-bargaining framework. In countries with flexible labour markets, the taxes tend to get shifted back onto labour, reducing the take-home wage. The effect on labour supply of this lower wage appears to be empirically small for men, but appears to be significant for women, for whom tax elasticity are high. In countries with inflexible labour markets, by contrast, labour taxes tend to get shifted forward to producers, at least in the short run, and therefore reduce labour demand. This reduces employment and lowers growth if lower demand for labour is not replaced by higher demand for capital, for example if investment reacts negatively to higher costs of production. Empirical work shows that labour-demand elasticity are much higher than overall supply elasticity, so that labour taxes tend to be much more distortionary in countries where there are inflexible labour markets, and most of the tax effect falls on the demand rather than the supply of labour. The absolute level of the labour-tax burden also tends to be high in such countries.

(e) The **substitution effect** is the change in consumption patterns due to a change in the relative prices of goods. For example, if private universities increase their tuition by 10% and public universities increase their tuition by only 2%, then it is very likely that we would see a shift in attendance from private to public universities (at least amongst students accepted to both). The same can be said across brands, goods, and even categories of goods. Examples would be the relative price of Pepsi vs. Coke, Red Meat vs. Poultry and Clothes vs. Entertainment. The **income effect** is the change in consumption patterns due to the change in purchasing power. This can occur from income increases, price changes, or even currency fluctuations. For example, a decrease in the price of all cars allows you to buy either a cheaper car or a better car for the same price, thus increasing your utility. Goods typically fall into one of two categories: normal and inferior. These categorizations relate consumption of a good with a particular individual's income. Normal goods increase in consumption as income increase while inferior goods decrease as income increases. Also, some goods can be normal or inferior only on certain ranges of an income spectrum. For example, education is a normal good: as one's income increases (family income), demand for education increases. As one's income increases, hot dog consumption, however, typically decreases. The income effect is the change in consumption patterns due to the change in purchasing power and the substitution effect is the change in consumption patterns due to a change in the relative prices of goods.

Answer to SEQ 12

Taxable capacity

(a) A brief definition of a taxable capacity

- Refers to the maximum amount, which citizens of a country can contribute towards the expenditure of the government without undergoing unbearable strain OR
- It is the upper limit of squeezability OR
- It is the maximum amount of taxation that can be raised and spent to produce the maximum economic welfare in the economy

(b) Factors which may affect a taxable capacity of a country

- **The population size and the rate of growth**
  Taxable capacity is likely to be low given small population/few taxpayers
- **The size and growth of Gross Domestic Product (GDP)**
  When GDP is rising tax will tend to increase
- **Method of taxation**
  Tax policy/system that allows for diversity is important
- **Income stability**
  Fluctuations, e.g. in production (due to factors such as weather etc) will affect the certainty, hence taxable capacity
- **Political stability**
  Political stability allows/provides conducive/favourable environment for people to work and also induce foreign investors, thereby contributing to GDP
- **Level and structure of trade openness**
  The higher the level of development of trade the higher is the taxable capacity
- **Inflation**
  Inflation tend to lower the purchasing power

(c) The buoyancy of a tax system is an estimate of how tax revenue changes as some general indicator of the economy such as Gross Domestic Product (GDP) changes. A buoyancy estimate does not control for changes in tax rates or bases and so may hide a number of changes in tax system. Still, in the long-run, buoyancy is a useful statistic that gives some indication of the stability of a particular tax. In contrast, the elasticity of a tax is the percentage growth in revenues relative to the percentage growth in GDP taking into account tax policy changes. Calculating elasticity is more difficult because it requires information on changes in both rates and bases and the necessary information on bases is often difficult to obtain.

Answer to SEQ 13

(a) The basis on which taxes are levied, can also be bifurcated into following three categories:

- **Progressive taxation**: a tax such as the income tax demonstrates the progressive principle. As income rises so does the proportion of tax i.e. the rate of tax rises as well as the amount of tax. This can be considered as just and fair, as the higher tax payments are made by those with higher incomes. Taxes which take a higher percentage of the incomes of higher income earners are said to be progressive.

- **Regressive taxation**: This is the tax where, as the amount of income increases, percentage of tax is reduced. So in this case, a tax payer in the high income group may be paying more taxes in absolute terms but the percentage of income is falling.

- **Proportional taxes**: In this case, as the tax payer's income increases, he pays more tax but the amount that is paid as percentage of the tax payer's income remains unchanged.

(b) This principle states that the every tax should be framed in such a manner that is takes out of the pockets of the people as little as possible, over and above what it brings into the public treasury. A good tax system will ensure that the cost of collecting and paying tax as well the compliance cost is minimum. For example, if there are many procedures for payment of tax and filing of related documents or if a number of visits are required by the tax payer to the tax office, then the tax system is said to be uneconomical. In a broader sense, if very high tax is levied on the income of the tax payer, it will discourage savings and the productive capacity of the economy will go down, which will be uneconomical for the State. Taxes on products like alcohol, cigarettes etc are considered as economical because they fetch revenue to the government as well as increase the price of those products which will discourage their consumption.

Answer to SEQ 14

(i) Calculate equilibrium quantity and price before taxation

- ✓ At equilibrium

$P_s = P_d$

$10 + Q = 100 – 2Q$

$2Q + Q = 100 – 10$

$3Q = 90$

$Q = 90/3$

$Q = 30$

In order to get Price P, take one of the equations and substitute Q with 30

Let take $P = 10 + Q$

Then $P= 10 + 30$

$P = 40$

Therefore,

Quantity (Q) = 30

Price (P) = 40

(f) Compute the price paid by consumer and price received by producer and quantity sold after taxation together with producer supply and consumer supply before and after taxation

In order to find the price paid and received by consumer and producer respectively you need to equate zero for quantity to demand and supply functions to get those prices.

Therefore

Demand function: $P_d = 100 - 2Q$

Make Q the subject

$P_d = 100 - 2Q$

$2Q = 100 - P_d$

$Q = (100/2) – ½ P_d$

$Q = 50 - ½ P_d$

Then Q= 0

$0 = 50 - ½ P_d$

$½ P_d = 50$

$P_d = 50 * 2$

$P_d = 100$

Supply function: $P_s = 10 + Q$

Make Q the subject

$P_s = 10 + Q$

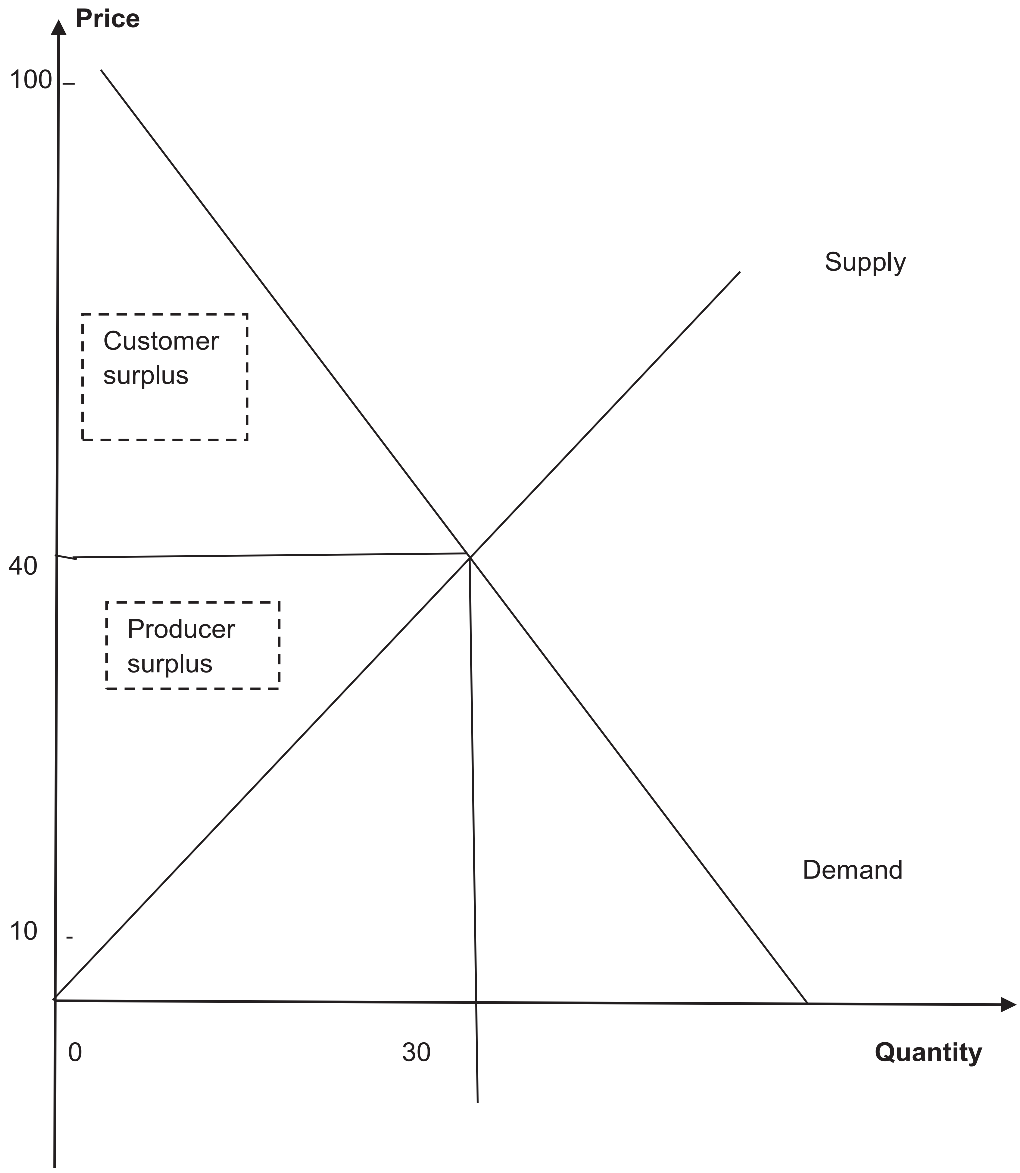
$Q = P_s - 10$

Then Q= 0

$0 = P_s - 10$

$P_s = 10$

Sketch graph of demand and supply before taxation



Using the graph above to compute

- ✓ Consumer surplus before taxation
  = ½ * base * height
  = ½ * 30 *60
  = 900
- ✓ Producer surplus before taxation
  = ½ * base * height
  = ½ * 30 *30
  = 450
- ✓ Total economic surplus = consumer surplus + producer surplus
  = 900 + 450
  = 1350
- ✓ Producer supply and consumer supply after taxation
  Step 1: add tax (t) to surplus function
  $P_s = 10 + Q + t$
  T is given, t = 15
  $P_s = 10 + Q + 15$
  $P_s = Q + 25$

Step 2: at New equilibrium $P_s = P_d$

$Q + 25 = 100 - 2Q$

$Q + 2Q = 100 – 25$

$3Q = 75$

$Q = 75/3$

$Q = 25$

Therefore in order to get P you substitute 25 to Q from any function

$P_s = Q + 25$

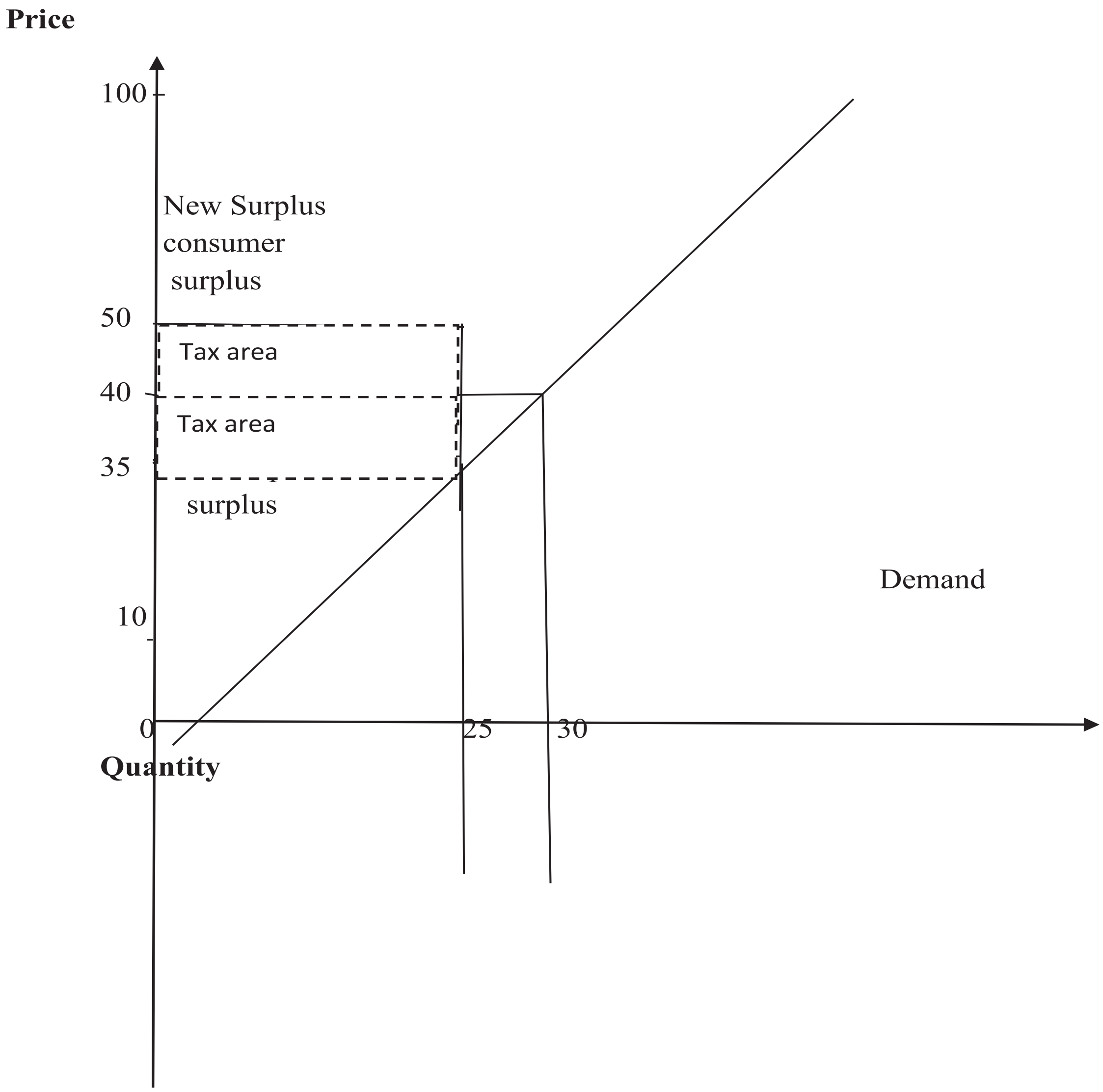
$P_s = 25 + 25$

$P = 50$

Therefore

- Price paid by consume P = 50
- Price received by producer (P – t) = 50 – 15= 35
- Quantity sold after taxation Q = 25

Sketch graph of demand and supply after taxation



Using the graph below to compute

✓ Consumer surplus after taxation
= ½ * base * height
= ½ * 25 *50
= 625

✓ Producer surplus after taxation
= ½ * base * height
= ½ * 25 *25
= 312.5

(g) Calculation of tax revenue to the Government and Dead Weight Loss (DWL)

✓ Tax revenue to the Government
= New quantity * tax
= 25 * 15
= 375

✓ Dead Weight Loss (DWL)
= ½ * tax * ΔQ
= ½ * 15 *(30 – 25)
= ½ * 15 * 5
= 37.5

(h) Calculation of price elasticity of demand and price elasticity of supply

✓ Price elasticity of demand e_d
$= \partial Q/\partial p * (P/Q)$
In order to get $\partial Q/\partial p$ make Q the subject
$P_d = 100 - 2Q$
$Q = 50 - ½ P_d$
Therefore
$\partial Q/\partial p = - ½$
Then
$e_d = \partial_Q/\partial_p * (P/Q)$
$= - ½ * 40/30$
$= - 0.67$

✓ Price elasticity of supply e_s
$= \partial Q/\partial p * (P/Q)$
In order to get ∂_Q/∂_p make Q the subject
$P_s = 10 + Q$
$Q = P_s - 10$
Therefore
$\partial_Q/\partial_p = 1$
$e_d = \partial_Q/\partial_p * (P/Q)$
$= 1 * 40/30$
$= 1.3$

(i) Calculation for share of tax revenue paid by consumer and share paid by producer

✓ Consumer/buyer
$= e_s / (e_s – e_d)$
= 1.3 / (1.3-(- 0.67))
= 1.3/ 2
= 0.65 * 100%
= 65%

✓ Producer / seller
$= e_d / (e_d – e_s)$
= - 0.67 / (- 0.67- 1.3)
= - 0.67 / -2
= 0.335 * 100%
= 33.5%

(j) The one who pays more tax is producer, since he/she cannot shift the tax burden by increasing price to the consumer

Answer to SEQ 15

(a) Tax on good and services distorts the relationship between demand and supply. Taxes have an effect on the amount of supply produced and consumer's demand for goods. Taxation puts both consumers and producers in a worse position because with the introduction of taxes, the price that consumers pay is higher than what they would have paid before. On the other hand, the price that producers get after the introduction of taxes is lower than what they would have received before taxation. The resulting change in relative cost of goods and services will have an effect of motivating consumers to switch from one product or activity to another. The act of switching from one product to another as a result of a tax, given a certain income level, leads to substitution effect. The substitution effect interferes with consumer choice and subsequently leads to economic inefficiency.

Taxes that affect relative prices and influence consumers to substituting consumption of the taxed commodity for another are also termed distortionary taxes and the substitution changes the consumer's tax liability.

The market has narrowed because lower quantity of goods is being exchanged. The decrease in consumers' and producers' welfare turns into tax revenue of the state. Thus, for the purpose of full understanding of the impact of taxes on welfare, the decrease in welfare of consumers and producers should be compared with the tax revenue collected by the state. Such an analysis will show that the decrease in consumers' and producers' welfare exceeds the tax revenue collected by the state.

The loss of welfare that takes place after introduction of taxes (a part of which belongs to no one – neither to a consumer or producer, nor to the state) represents a dead weight loss or excess tax burden, or a degree of inefficiency that taxes introduce to the economy.

(b) Impact of tax on savings of individuals

The gross savings in private sector are accumulated in households and companies. However, a large part of the gross savings is used for covering depreciation and is needed for the maintenance of the existing capital. The net savings, consisting of savings in households and retained earnings of companies, represent the real potential, available for new investments. The major part of these savings is accumulated in households, while the retained earnings account for only a small part of them.

If all individuals would save the same proportion of income, then the impact of income tax on the total savings would be the same, regardless of the pattern of the distribution of tax burden to individuals. But, wealthy individuals save more than poor citizens, so it is expected that the taxes collected from higher tax brackets create more burden on savings than the ones collected from lower tax brackets. Consequently, a more progressive income tax seems to be creating a heavier burden on savings than a less progressive tax system.

Income tax also affects savings by lowering the net return from savings, that is, by lowering the interest rate on savings. In such conditions, savings are expected to drop. However, the savings of individuals are motivated with various other reasons and their final amount does not have to depend on interest rate trends only. For example, many households will not save less when interest rates are lower, because they are in that part of life cycle when they have to save for retirement.

Besides income tax, consumption tax also affects savings of individuals. While income tax is generally progressive, consumption taxes are mostly regressive, that is, they are mostly paid by lower-income households. Since these households have a higher marginal propensity to consume than the households with higher income and since their marginal propensity to save is lower than the one of wealthy individuals, consumption taxes burden total consumption more and savings less. This is why it is often recommended to the countries with low level of savings that they should direct their tax systems to taxation of consumption much more, because this will boost savings and growth, too.

Impact of tax on gross savings of companies

Retained earnings and depreciation reserves account for the predominant part of company savings. Since profit is taxed after deduction of depreciation income tax does not reduce the depreciation reserves. But if profit taxation law allows accelerated depreciation, then depreciation reserves and company savings will increase in the first years following the purchase of fixed assets. Profit is divided in the dividends distributed to company owners and undistributed profit remaining in the company.

Different taxation of the dividends and retained profit has an impact on savings, too. Higher taxation of the retained profit will stimulate its distribution to dividends, while lower taxation of the retained profit will increase the company's savings. The amount of savings also depends on whether profit taxation system and income taxation system are reconciled. If they are double taxation of the dividends on company level and again on the level of individuals is thus avoided.

(c) Impact of tax on Producer and consumer surplus

The addition of the tax will also remove some consumer and producer surplus. Consumers are forced to pay more for the same good because the price has risen. Meanwhile, producers are losing out on potential profits because their revenue has not increased by as much as the price rise would suggest. Total surplus will therefore be reduced, because people and firms sell or buy less of a good when the tax adds to its price. The effective price paid may rise, causing the demand curve to shift to the left, or the effective price received may fall, causing the supply curve to shift to the left, creating the Deadweight Loss. This means that some people that would have engaged in trade without the tax, no longer are "willing and able" to buy or sell the good, meaning their surplus disappears, and the tax revenue that would have been derived from their market participation disappears as well. Thus, taxes always cause deadweight Losses for society and always negatively affects the free market system.

(d) Tax impact on Consumption on wages and employment

Beside direct taxes, indirect taxes (that is, consumption taxes) also have impact on the supply of labour by reducing the purchasing power of net wage. However, workers seem to be reacting somewhat slower to a change in the consumption taxes, and the impact of the consumption taxes on labour supply also appears within a longer period of time than normally is the case with direct taxes.

Taxes on labour income and consumption spending encourage households to shift away from work in the legal market sector and toward untaxed used of time such as leisure, household production, and work in the shadow economy. Empirical evidence also show that taxes affect work activity directly through labour supply-and demand channels and indirectly through government spending responses to available tax revenues. Higher tax rates on labour income and consumption expenditures lead to less work time in the legal market sector, more time working in the household sector, a larger underground economy, and smaller shares of national output and employment in industries that rely heavily on low-wage, low skill labour inputs.

Answer to SEQ 16

(a) The sacrifice Theory

Impose taxes on basis that would involve equal sacrifice:

- Equality of sacrifice by itself does not necessarily imply progressive taxation.

- If the marginal utility of income or wealth decreases the richer ones is then a given amount of tax falls more lightly on the richer than on the poor.

Ability to pay Theory

- People with higher incomes should pay more than those with lower incomes.
- The value of an additional dollar of income falls as income rises.

- The ability to pay criterion does not necessarily justify regressive proportional or progressive taxes.

Relationship

The ability to pay approach treats government revenue and expenditure separately. Taxes are based on tax payers' ability to pay, there is no guild pro quo. Taxes paid are seen as a sacrifice by tax payers, which raise the issues of what the sacrifice of each tax payer should be and how it should be measured.

(i) Equal sacrifice. Total loss of utility as a result of taxation. Should be equal for all taxpayers the rich will be taxed more heavily than the poor.
(ii) Equal proportional sacrifice: The proportional loss of utility as a result of taxation should be equal for all taxpayers.
(iii) Equal marginal sacrifice: the instantaneous loss of utility as measured by the derivative of the utility function as a result of taxation should be equal for all tax payers. This will entail the least aggregate sacrifice (the total sacrifice will be the least).

(a) Benefit principle versus sacrifice and Ability to pay Theory:
The benefit principle differs radically from the sacrifice and ability to pay theories of taxation.

The sacrifice and ability to pay principles depart completely from the principles of action and the accepted criteria of justice on the market. On the market people act freely in those ways which they believe will confer net benefits upon them. The result of these actions is the monetary exchange system with its in exorable tendency toward uniform pricing and the allocation of productive factors to satisfy the most urgent demands of all the consumers.

The sacrifice and ability-to pay principles forget about. The free choice and uniform pricing and the discussion is all interims of sacrifice, Burden etc.

If taxation is only a burden, it is no wonder that coercion must be exercised to maintain it. The benefit principle on the other hand is an attempt to establish taxation on a similar basis as market pricing that is, the tax is to be levied in accordance with the benefit received by the individual.

It is an attempt to achieve the goal of a neutral tax one that would leave the economic system approximately as it is on the free market. It is an attempt to achieve phraseological soundness by establishing a criterion of payment on the basis of benefit rather than sacrifice.

Answer to SEQ 17
Investment tax incentives

(i) **Features of investment tax incentives**

Tax incentives are special provisions in the tax laws which allow an exclusion from income, a higher-than usual deduction or special deduction, a tax credit, or a reduction in the tax rate. They are fiscal measures that are used to attract local or foreign investment capital to certain economic activities or particular areas in a country. Tax incentive comprise all measures that provide for a more favourable tax treatment of certain activities or sectors compared to what is granted to general industry or economy. Through tax incentives, governments try to reallocate or attract domestic and foreign capital **using selective tax incentives** that give a **more favourable tax treatment to certain** economic activities.

A **key feature** of any definition of tax incentives **is the preferential treatment of particular taxpayers relative to others**.✓ From these definition, **any tax provision that is applicable to all firms** or **all investment projects non-discriminatorily does not constitute a tax incentive**. Thus tax incentive definition **excludes "general tax incentives," such as accelerated depreciation that applies to all investments**. Also, both local and foreign investors may be targeted by the tax incentives policy.

(ii) Fundamental premises that underpin the case for tax incentives in developing countries. Candidates are expected to discuss the arguments in favour of investment tax incentives. There are several arguments, but a minimum of seven (7) arguments is sufficient.

- Investment tax incentives enhance return on investment
  Additional investment is needed to foster more rapid economic growth. Tax breaks can be effective in stimulating investment.
- May be justified by positive externalities stemming from investment
- They are relatively easy to target and fine tune.
- They are necessary for responding to tax competition from other tax jurisdictions.
- Compensate for other deficiencies in the investment climate.
- Enhance revenue by stimulating investment that generate other taxable income via employment and linkage effects.
- Offer political advantages over direct expenditure programs to stimulate investment.
- Tax incentives have been successfully used in well known cases/countries.

(iii) Case (arguments) against tax incentives (any eight arguments)

- The actual revenue cost can be high if the investment would have been viable anyway.
- Abusive tax avoidance schemes (e.g. transfer pricing) further erode the tax base.
- Tax incentives divert administrative resources from revenue collection.
- The revenue losses requires painful fiscal adjustments in the form of higher taxes on other entities.
- Tax differentials can introduce serious distortions that reduce efficiency and productivity.
- Tax preferences create inequities by favouring some tax payers over others. This can undermine general compliance (encourages evasion and avoidance).
- As a development tool tax incentives score poorly in terms of transparency and accountability (engender low level of transparency and political accountability).
- Stimulate political manipulation and corrupt practices.

- Alternative instruments for promoting investment can have much more favourable and lasting effects on productivity, growth and development International experience shows that tax incentives most often do not deliver favourable results.

Answer to SEQ 18

Advise on measures to improve governance in taxation

Government is advised to do the following:

Make public a statement of all tax incentives for investment and their objectives within a governing framework.

Tax incentives should only be granted in accordance with a comprehensive policy, which lays down principles and policy objectives for the introduction or continuation of a tax incentive. Governments should provide a justification for tax incentives (e.g. regional/territorial development, employment creation) with the expected costs and intended benefits. This should be communicated publicly through a regularly updated statement. Such a statement provides the basis for the assessment of the performance of tax incentives, any overlap and duplication and allows for governments to be held accountable for the tax incentives they have granted.

Provide tax incentives for investment through tax laws only

Tax incentives for investment are currently provided through tax laws e.g. income tax law), but in many cases are also provided by laws governing investment, Export Processing Zones, Special Economic Zones, etc. and in other cases, through decrees, agreements and regulations. As a result their true extent may be hidden. All tax incentives provided, along with their eligibility criteria, should be consolidated and publicized in the main body of tax law. Bringing tax incentives into the tax laws (or mirrored in the tax laws) increases transparency and may empower the tax administration to administer them. Those tax incentives that are used should be as simple as possible to both apply for and administer.✓

Consolidate all tax incentives for investment under the authority of one government body, where possible

All tax incentives should be placed under the authority of one government body, ideally the Ministry of Finance. Currently, the granting and administration of tax incentives may be the responsibility of finance, trade, investment or other ministries, **increasing the risk of corruption and rent seeking**. Consolidating them under a single body **increases transparency**, helps to avoid **unintended overlap and inconsistencies in incentive policies, limits discretionary power and enables policy makers to address problems that may arise with the governance of tax incentives**. In countries where the granting and administration of tax incentives is decentralized and/or carried out by both the central and sub-national governments, to the extent possible, various levels of government should coordinate to maximize the efficiency and transparency of their efforts.

Ensure tax incentives for investment are ratified through the law making body or parliament

Tax incentives provided through executive decrees or agreements when not scrutinized by the law making body do not provide sufficient transparency in their granting and operation. **Parliamentary oversight, or its equivalent, is fundamental to transparency and accountability in the governance of tax incentives.** This ensures incentives are subject to scrutiny on their intended purpose and their costs as well as benefits to the country.

Administer tax incentives for investment in a transparent manner

Once provisions have been enacted in the relevant tax laws and regulations, tax incentives may be claimed by a taxpayer by meeting the necessary conditions as prescribed, without negotiating with any granting authority, except as provided for under the relevant tax laws. A minimum necessary condition to be met by taxpayers in the case of a tax incentive should be requirement to file a tax return in the case of VAT and Income Tax, and in the case of other taxes a statement detailing the duty or other exemptions availed in the prescribed period. In addition to enhancing efficiency transparency, such taxpayer information contributes to data for deterring the efficiency and equity of tax incentives. Tax authorities should also periodically carry out audits of cases where tax incentives have been claimed to ensure that they are not misused.

Calculate the amount of revenue forgone attributable to tax incentives for investment and release a statement of tax expenditures to the public

The amount of revenue loss attributable to tax incentives should be reported regularly, ideally as part of an annual Tax Expenditures Report (covering all main tax incentives). While cash expenditure budgets are usually scrutinized on a yearly basis, the revenue cost of tax incentives is hidden when estimates of revenues forgone are not calculated and reported. Embedding estimates of revenues forgone by tax incentives in the yearly budget process provides policy makers with the required inputs on a timely basis to inform policy decisions. It also supports medium term fiscal planning as what seems like a small amount of foregone revenue in good fiscal times may become quite high during periods of fiscal strain. The calculation of revenue forgone should recognize that the benefits of some investments, mineral extraction, for example, may take many years to realise so losses should be assessed over the life of the business concerned.

Highlight the largest beneficiaries of tax incentives for investment by specific tax provision in a regular statement of tax expenditures, where possible

It may be possible ha a few investors, or sectors, benefit from most tax expenditures. The tax expenditure statement should have sufficient detail to enable policy makers to identify which sectors benefit from specific tax provisions and, where this is compatible with the requirement of laws and regulations governing taxpayer confidentiality, authorities may wish to consider detailing the major beneficiaries and the amount by which they benefit from tax incentives. Making such information public can enhance the legitimacy of governments and their revenue authorities in the eyes of citizens which in turn can enhance compliance more broadly.

Collect data systematically to underpin the statement of tax expenditures for investment and to monitor the overall effects and effectiveness of individual tax incentives

Analysis of tax incentives is data intensive – required for public statement, budgeting, periodic reviews, tracking of behavioral responses by business, etc. There is a need for the periodic collection of taxpayer's data and on-going analysis of these data by revenue authorities. This may require introducing mechanisms to do so in some countries.

Enhance regional cooperation to avoid harmful tax competition

In many cases tax incentives are provided in response to what neighbouring countries and competitors are offering or received to be offering. Hence the issues of tax incentives cannot be tackled in isolation. Governments can work together on a regional basis to increase cooperation in the area of tax to avoid a race to the bottom when they provide competing tax incentives. Efforts to enhance regional cooperation should also cover the use of non-tax instruments e.g. cash subsidies and loan guarantees which also provide incentives for investment.

Answer to SEQ 19
Comment on the use of tax exemption/fiscal incentives strategy to induce FDI

In countries where the investment climate is good, the effect of lowering effective tax rates on FDI is positive, while in countries with poor investment climate – that includes Tanzania and other developing countries – the effect is almost non-existent. This important observation suggests that it is more efficient for low income developing countries to focus on improving their investment climate rather than granting tax exemptions to corporations. There is some (substantial) evidence which has confirmed that before investing in Tanzania businesses will consider other (more important) factors than the level of tax exemptions they could get (see the factors below). Most important factors that impact decision to locate investment in a particular country, in the order of importance, are market potential, electricity, good roads, raw input, water infrastructure, access to finance, business support, labour costs, port proximity, local suppliers, access to land, free zone, exchange rate, affordable labour, legal system, tax incentives, duty free imports, protective tariffs, competitor presence, repatriate dividends, competitive labour.

In this list, tax incentives and duty free imports do not appear to be the most important criteria investors base their decision while assessing/deciding where to locate their businesses. This is, however, not to say tax benefits should be abolished completely or kept very low, rather should be neutral and not necessarily over generous.

SECTION A

PUBLIC FINANCE AND NATIONAL INCOME

A4

STUDY GUIDE A4: PUBLIC EXPENDITURE

Get Through Intro

Governments are entrusted with not only setting the legal code ("laws of the land") that organisations must abide by, but also with shaping the external environment or macro economy that they have to operate in. Public expenditure is an important facet of macroeconomics as it relates to the spending by public authorities like central, state and local authorities on various activities for achieving social and economic objectives.

As an accountant, it is important that you understand the various facets of public expenditure which are discussed in this Study Guide as public expenditure policies shape the economy. This is because changes in a government's economic policies will undoubtedly affect your organisation in some way.

This Study Guide will provide you with meaning, objectives and cannon of public expenditure, an analysis of the classification of government expenditure, the factors which affect the size and growth of public expenditure, an understanding of the institutions which implement expenditure policies and the project evaluation techniques which can be used by public bodies.

Learning Outcomes

a) Explain the meaning, objectives, classification and canons of public expenditures.
b) Examine factors affecting size and growth of public expenditure.
c) Describe theories of public expenditure (Wagner's laws of increasing state activities and Wiseman-Peacock Hypothesis)
d) Identify the criteria of assigning public expenditure across different levels of government.
e) Describe the institutions and instruments involved in implementation of expenditure policy (executive, parliament audit).
f) Describe public sector expenditure management tools (budget, parliamentary process, and accounting and audit)
g) Apply the decision rules in project evaluation under different budget scenarios (budget size fixed, budget size variable, lumpy projects)
h) Describe issues and challenges relating to government expenditure

Explain the meaning, objectives, classification and canons of public expenditures; examine factors affecting size and growth of public expenditure; Describe theories of public expenditure (Wagner's laws of increasing state activities and Wiseman-Peacock Hypothesis)

[Learning Outcome a, b, c and d]

1. Meaning, Objectives, Classification and Canons of Public Expenditures.

1.1 Meaning of public expenditure

Government or public expenditure can be defined as the spending by public authorities like central, state and local authorities on various activities for achieving social and economic objectives. Therefore it also includes amounts spent for protecting citizens and amounts incurred to satisfy the general common needs of the public at large. Thus it brings about social as well as economic development of the state.

1.2 Objectives of Government Expenditures

i) To provide essential goods and services to the public such as education and health.
ii) Regulation of economic activities in the public interest, example control of monopoly.
iii) Influence allocation of resources in order to improve efficiency example by providing subsidies to small scale firms.
iv) Allocation function: This is where appropriate corrective action is taken in circumstances where private markets fail to provide the combination of goods and services desired by people.
v) Redistribution of incomes by providing loans and free social services to the poor.
vi) Stabilization of the economy, example controlling unemployment problem by increasing expenditures on economic and social services which help to stimulate investments.

1.3 Classification of government expenditure

Government spending can be analysed in three ways:

1. Administratively

This classification is based on the terms of who is responsible for the expenditure and by implication the activities that drive it.

Responsibilit	Example of government expenditure	Amount incurred
Central government	Defence, providing infrastructure relating to national highways, airways, sea ports, building industrial zones	Total amount incurred by central government for providing the various services (discussed in the adjacent column
Local government	Primary education, local health service, Agriculture extension and livestock development, water supply and local road maintenance.	Total amount incurred by local government for providing the various services (discussed in the adjacent column)
Total amount		Total amount

The above classification will split the entire expenditure of an economy into central government expenditure and local government expenditure.

2. Functionally

This classification is based on the terms of what the spending has been upon. Therefore the total public expenditure of an economy is split up based on the nature of services provided i.e. the total expenditure is split into defence expenditure, national highways expenditure, total local health services incurred by various local governments, total local road maintenance expenditure incurred by the various local governments of the economy, and so on.

Type of expense (examples)	Total amount
Defence expenditure	XX
National highways expenditure	XX
Total local road maintenance expenditure incurred by the	XX
Total local public health expenditure incurred by the various local governments of the economy	XX
Total expenditure of the economy	**XXXX**

3. Economically

This classification is based on the terms of its purpose such as infrastructure, social, health or other policy purpose. Therefore the total expenditure of the economy will be split up in this way.

(a) **Recurrent expenditure** is expenditure incurred for the day to day operations of the government like salaries and wages of employees and other overheads, healthcare services, education etc.

(b) **Development expenditure** is expenditure incurred towards improving infrastructure like roads, bridges, supply of electricity and water etc.

Other classifications

4. Classification based on necessity

This classification was advocated by Professor Mill. He classified public expenditure as necessary and optional, and advocated that the state may undertake 'optional' expenditure.

5. Classification based on nature

This classification is based on the nature of the expenditure. Public expenditure is incurred for individuals or groups of individuals. It is classified as fixed and variable expenditure.

(a) **Fixed expenditure** is that portion of public expenditure which is fixed and has no relationship to the quantum of usage of services. For example, defence expenses, amounts incurred on street lighting etc. Major portion of the expense incurred is fixed in nature; however, it does have an element of variability in it.

(b) **Variable expenditure** is that portion of public expenditure which is variable i.e. the amount incurred has a direct relationship with the quantum of usage of services. For example amounts incurred for postal service, railway services etc.

6. Classification based on urgency

This classification based on the urgency of usage is as follows:

(a) **Necessary expenditure** is expense which cannot be avoided (like defense expenses).

(b) **Useful expenditure** is expense which can be postponed for some time (like construction of an additional bridge over a river).

(c) **Superfluous expenditure** is expense which can be avoided altogether as it is neither useful nor profitable.

7. **Classification based on productivity**

This classification of government expenditure is as follows:

(a) **Productive expenditure** relates to expenditure which causes increase in national income due to development / more efficient usage of national or human resources of the economy (e.g. expenditure for setting up an industrial estate in a city).

(b) **Non-productive expenditure** relates to expenses which do not cause increase in national income (e.g. war expenses).

Structure of Government Expenditure in Tanzania

Public expenditure in Tanzania is broadly classified into two main heads: recurrent and development expenditure.

(c) **Recurrent expenditure** is expenditure incurred for the day to day operations of the government like salaries and wages of employees and other overheads, healthcare services, education etc.

(d) **Development expenditure** is expenditure incurred towards improving infrastructure like roads, bridges, supply of electricity and water etc.

This expenditure is further divided into Ministerial and Regional and Local government expenditure.

(a) **Ministerial and regional expenditure** is the expenditure for which the responsibility is on the Ministers of Central Government.

(b) **Local government expenditure** is incurred by the local authorities like municipalities for the local jurisdiction.

1.4 Principles of public expenditure

The main principles of public expenditure are:

i. **Maximum social benefit**: it is necessary that all public expenditure be **utilised for the general welfare of the society** at large, and not for the benefit of a particular section of the society.
ii. **Economy**: public expenditure has to ensure economy, i.e. **all wasteful and unprofitable expenditure has to be avoided.** It should be ensured that the tax-payer is not burdened to the extent that his savings are affected.
iii. **Approved expenditure**: it is necessary to ensure that public expenditure is **approved by a competent authority** and that funds are used for the purpose for which they were approved.
iv. **Flexibility**: it is necessary that an element of flexibility exists so that **expenditure can be varied according to needs and circumstances**.

2. Factors Affecting Size and Growth of Public Expenditure.

Several factors have led to an increase in public expenditure in Tanzania overtime include the following:

(a) **Growing Population**

A high growth rate of population naturally calls for increase in public expenses as all state functions are to be performed more extensively, Population growth has made necessary for governments of most countries to spend increasing amounts on education, health, infrastructure, subsidies and social security.

(b) Defense Expenditure

The defense expenditure of the Central Government has increased over the years due to modernization of defense equipment by Navy, Army, and Air forces to prepare the country for war or prevention. Furthermore the defense expenditure minimizes the possibility of external threats, which in turn creates a good environment for social and economic activities of the nation.

(c) Interest Payments

Government borrowings are on increase. The government borrows funds from domestic market and foreign sources to meet expenditure on various government activities. As a result, the government has to incur huge interest payments. Example borrowing from IMF, WORLD BANK, AFRICA DEVELOPMENT BANK. The extent of past government borrowing: governments indulge in external borrowings in order to fund development, in times when they face budget deficits. This in turn implies that the government will have to incur recurrent expenditure towards payment of interest and repayment of principal amount of borrowing.

(d) Subsidies

Government of Tanzania has been providing subsidies on number of items such as food, fertilizers, education. Because of massive amount of subsidies, the government expenditure has increased over the years. In order to reduce unproductive expenditure, Central Government must make attempts to reduce subsidies.

(e) Administration

The Central Government expenditure on administration has increased due to growth in population and economic development.

(f) Rise in National income

The national income of the country has shown an increasing growth rate over the last 10 years. The increase in national income resulted in more revenue to the government by way of tax revenue and other income, which in turn enabled the government to increase its expenditure.

(g) Urbanization

Urbanization has led to increasing expenditure on civil administration. Government expenditure on courts, police, transport, railways, schools and colleges, public health measures, water and electricity supply, public parks, libraries have increased due to growth of towns and cities.

(h) Rural Development

In developing countries, government has to undertake community development projects and other social measures to promote rural development. Such measures cause a rise in public expenditure.

(i) Increase in Inflation

Rise in prices have caused an increase in public expenditure. The cost of supplying public goods and services has increased. Rising prices have also necessitated the payment of higher salaries and allowances.

(j) Democratic Government

A democratic government has to incur increasing expenditure on elections, legislatures, ministries, international conferences, embassies abroad. Public expenditure also increases when a country becomes a member of international organizations like UN, WHO, AU.

(k) Social Security Measures

For the welfare of the people government provides social security measures which increase its expenditure. It provides measures such as sickness benefits, old – age pensions, free education, medical facilities, public work and relief programmes.

(l) Growth of Transport and Communication

The government has to incur huge expenditure on construction of railways, roadways, national highways, and bridges so as promote mobility and economic development. Thus with growth of transport and communication public expenditure have increased.

(m) Development of Agriculture

The government may develop agriculture by providing seeds, fertilizers, irrigation facilities, modern implements, cheap loans, all these will increase public expenditure. The intervention to increase government spending aimed at expansion and construction of new irrigation infrastructures, purchases of agricultural implements and inputs, improving marketing infrastructure. National Food Reserve to assure food security for Tanzanians on a Sustainable basis and provision of loans and credit services to smallholder Farmers through Tanzania Investment Bank and Agriculture Development.

(n) Development of Industry

The government may encourage the growth of private industries through protection, subsidies to exporters, and loans at cheap rate of interest causing a rise in public expenditure.

(o) Poverty Alleviation Programmes

In developing countries, government are spending a good amount of funds on poverty alleviation and employment generation programmes, some of the programmes like KILIMO KWANZA, MKUKUTA and MKURABITA.

(p) Research and Development

Research and Development is important to improve quality and to reduce costs. The government finances Research and Development projects undertaken by non-government organizations, universities and other educational organizations.

(q) Economic Planning

To promote rapid economic development modern governments adopt economic planning. The public sector outlay on various sectors has been increasing with the increasing role of government.

3. Theories of Public Expenditure

(a) Wagner's law of increasing state activities

According to this theory, there are inherent tendencies for the activities of different layers of a government such as central and local governments to increase both intensively and extensively.

- There is functional relationship between growth of an economy and government activities.
- The following reasons support inherent long-term tendency of increasing public expenditure
  - Expansion in the traditional functions of the government
  - Growing population
  - The size and nature of public services
  - The need to provide an expand public goods
  - Price tendency (of going up)
  - Etc.

(b) Wiseman-Peacock Hypothesis

i) According to this hypothesis, public expenditure does not increase in a smooth and continuous manner, but in jerks or step-like fashion.

ii) That is, at times, social or other disturbances take place, creating a need for increased public expenditure which the existing public revenue cannot meet.

Hence, the government is forced to increase field of activities with corresponding increase in public expenditure.

4. Criteria of Assigning Public Expenditure Across Different Levels of Government.

Public expenditure should be incurred bearing in mind the main principles of public expenditure. Therefore at the most fundamental level government spending decisions could be seen as part of the overall economic problem of allocating scarce resources amongst competing needs and requirements. However **with government spending the process is not undertaken within a free market pricing system** that works based on the interplay of supply and demand to satisfy those consumers who are able and also willing to participate to acquire economic goods.

With government spending the allocation of scarce resources is based on decisions in a democratic process that supports primarily the provision of what most people would see as social goods that they believe should not command a price like economic goods. Therefore the criteria used in assigning public expenditure across government sectors are as follows:

(i) **Strategic significance:** Public expenditure needs to be spent in accordance with key strategic government objectives such as the MKUKUTA strategic interventions. Is the sector already prioritized in the national strategy? Does it contribute to the country's profile? Does the sector have central strategic significance as an enabler for other sectors? If it has these significances, it needs to be a priority sector for government spending.

(ii) **Economic growth:** Public expenditures need to be assigned towards sectors that account for a significant proportion of the country's GDP. If the sector has a quick growth and is such that in the future will contribute largely to the national income, it deserves to be a priority sector.

(iii) **Extent of employment:** The government priority in spending shall also consider the sectors which provide significant employment opportunities. Thus, if the sector employs a large number of workforces it needs attention and is thus a priority sector. If employment is likely to grow significantly it potentially propels income growth and so deserves to be a priority sector.

(iv) **Productivity:** Another criterion that needs consideration when assigning public expenditure is the sector productivity level or the potential for the sector to become a high productivity area.

(v) **Enterprise, innovation, and investment:** If a sector provides potential for new startup, it is innovative, it use new technologies, includes a significant number of companies that trade in new international markets, and attracts substantial inward investment; it deserves to be a priority growth sector.

Describe the institutions and instruments involved in implementation of expenditure policy (executive, parliament audit); Describe public sector expenditure management tools (budget, parliamentary process, and accounting and audit); Apply the decision rules in project evaluation under different budget scenarios (budget size fixed, budget size variable, lumpy projects); Describe issues and challenges relating to government expenditure

[Learning Outcome e, f, g, and

5. Institutions and Instruments Involved in Implementation of Expenditure Policy

(a) Par lia me nt

In a parliamentary democracy, leaders, parties and candidates for key presidential positions, cabinet membership, parliamentary seats or local government positions have to present plans in the form of papers, presentations, and arguments in debate and in published manifestos. Once elected, these leaders, cabinet ministries, etc. and later communications provide a mandate for the government in power to operate including many aspects that impact on public spending. The democratically elected government has to work within parliamentary democracy in putting forward proposals, papers and ultimately legislation that is worked upon subject to amendment and then voted for to become law. Once again, this will drive many public spending decisions. Parliament is often described as the legislature since that is its purpose and function. Parliament may sometimes delegate matters to parliamentary or cross parliamentary committees who will then propose legislation and amendments to parliamentary votes. Government and the cabinet has power, but power within a framework of supervision and approval by the legislature or parliament to whom they are accountable.

(b) Exec utive s

Whilst governments and parliamentarians may come and go with democratic elections, a permanent executive exists below them as a structure of largely full-time paid management and staff. Employees do come and go but their offices and positions are more permanent institutional structural mechanisms and process elements. Sometimes some are referred to as the civil service.

Civil servants and public sector staff work in a range of different entities with different functions and purposes:

Example

Sometimes called MDAs they are the ministries, departments and agencies of central and local government.

Ministries
Funds
Independent departments
Authorities
Agencies
Boards
Councils
Commissions
Local governme nt etc.

There are also other state entities:

Embassies
Hospitals
Education

And not forgetting the legal bodies and courts:

The judiciary and its courts

Ministries are particularly important in providing policy advice and support to government through working on proposals given to them and putting proposals forward that support government policy. All MDAs and state bodies have budgets with a variety of funding and revenue streams and expenditure plans.

Government can influence, control and use these budgets for policy purposes. However the bodies may have statutory obligations to fulfil such as defence, policing, law, social or educational provision etc. and have to provide these by law.

(c) Audit

To support accountability, most of these bodies are subject to independent audit by the state audit function or National Audit Office of Tanzania. Their audit work is of systems and operations in terms of compliance, efficiency, economy and effectiveness in process and procedure.

Heads of government bodies are also accountable for their spending to the office (CAG) of the Controller and
Auditor General who then focuses on four key issues:

- The account of expenditure
- Comparison against appropriated or agreed amounts
- Performance against agreed targets in terms of effectiveness
- Asset analysis and spend

Audit plays a key part in ensuring spending is properly authorised and reflects decisions made through budgets laws and regulations as well as statutory obligations.

6. Public Sector Expenditure Management Tools

One of the important functions of the government is to collect resources from the economy and use them for implementing policies relating to achievement of social and economic objectives. The economic objectives can be met only if the resources are used efficiently and effectively. Management of public expenditure is very critical for any economy. Public expenditure is the means through which public policies are implemented. Misallocation or misuse of public funds can pose serious problems to the society. Tax payers are concerned about the amount they pay to the government in the form of taxes and the benefits that they receive from the government in return.

Efficient management of public expenditure is necessary in order to ensure credibility of the government. Economists / analysts working on fiscal policies need to understand thoroughly how the expenditure side of public finance is managed. Public expenditure management is concerned primarily with the budgeting total revenue and expenditure, allocation of resources among various sectors and efficiency of execution of budgets. Budgets should take into account all the expected expenditures which are to be met as per the decisions made by the government at the stage of planning itself, and should focus on priority areas.

Efficient public expenditure management can be achieved with the help of the following tools:

(i) **Accuracy in budget preparation**

Budget planning and preparation is very critical to good public expenditure management. While formulating a budget, it is **necessary to obtain consistent and reliable data on past public expenditures** in order to budget for the current period**. Past experience should be taken into account** so that past errors may be rectified. A number of other factors need to be taken into account to ensure a sound budget:

- Completeness of coverage of all expected expenditure
- Usage of realistic and reasonable assumptions
- Usage of realistic projections for expected revenue
- Inclusion of provision for change in costs
- Inclusion of provision to meet unexpected expenditures

It is necessary to ensure proper control over total expenditure and minimise the cost of budget management.
Productive efficiency and efficient allocation of resources also helps in public expenditure management.

Disclosure of all relevant public revenue and expenditure information is important for accountability of government and to reduce corruption.

Public participation in the budget process for a pre-defined part will also help in better accountability and transparency.

Priority areas need to be identified at the time of budget preparation itself so that funds are not spent excessively on non- priority areas. It is also necessary that proper classification is made between implementing agency (administrative function), purpose of expenditure (functional classification) and use of expenditure (economic classification).

(ii) **Budget execution**

Once the budget is approved at the Central Government level, the responsibility of execution generally lies with the ministries and other appointed agencies. The ministries should ensure that they adhere to the spending limits laid down by the Central Government and regularly report to the government. Monitoring is generally done at the central level on an aggregate basis and appropriate responsibility should be placed for the monitoring. It is necessary for the Ministry of Finance to ensure that it obtains reliable data on expenditure from the executing agencies at regular intervals and analyse it effectively. This will help in overall control of expenditure.

Factors that are important in budget execution are whether the targets are likely to be met and whether the expenditure is likely to exceed budgets. It is important that the monitoring process is such that expenditure incurred will be within the budgeted amount and appropriate measures, if required, are taken to control expenditure.

(iii) **Cash planning**

Adequate cash planning is necessary to so that the government is able to meet budgeted expenses and unexpected expenditures without resorting to additional borrowings. It also helps in ensuring that the budget targets are met and the economic policies are implemented smoothly. Even though the budget has been prepared well and with adequate planning, liquidity problems may arise as the timing of cash inflows and outflows may vary. In order to ensure timely availability of cash for meeting expenditure, the government needs to prepare an annual cash flow forecast (bifurcated month-wise) at the beginning of each year.

It can take into account the past experience and future projections while preparing the cash flow forecast. If a shortfall of cash is expected in a particular month, the government can either postpone the expenditure or make arrangement for collecting additional revenue. The monthly projected cash flow should be updated with actual figures on a regular basis so that it helps in achieving budgeted targets. Quick updating of information is possible only with a well-established reporting system.

(iv) **Well-defined expenditure policies**

Policies that are well defined need to be framed along with projections of estimated expenditure to be incurred in relation to those policies.

(v) **Information on public revenue**

It is necessary to inform the citizens about the sources and amounts of public revenue and how these are managed by the government since the quantum of revenue determines the amount available for public expenditure. This will help citizens to monitor how public funds are being used and managed.

(vi) **Public expenditure tracking**

The tracking of public funds will ensure that funds are used for the purpose for which they were allocated and were intended to be used. This tracking must be quantitative as well as qualitative. Quantitative tracking is in the form of verifying records whereas qualitative tracking may be in the form of assessing from beneficiaries their opinion on the quality of services, technical reviews etc.

(vii) **Accounting**

The accounting categories and classification for budgeting as well as actual accounting should be common at the Central Government level so that accurate analysis is feasible. Accounting needs to be done on a timely basis and should be reliable. Appropriate processes for analysis of the accounts should be established.

(viii) **Audit**

An independent authority should be responsible for undertaking the audit of the entire process of public expenditure management.

8. Decision Rules In Project Evaluation Under Different Budget

Expenditure evaluation for many is seen as **a way of evaluating competing priorities for spending from the scarce resources of a revenue budget.**

The theories help build a model for evaluating one priority
against another.

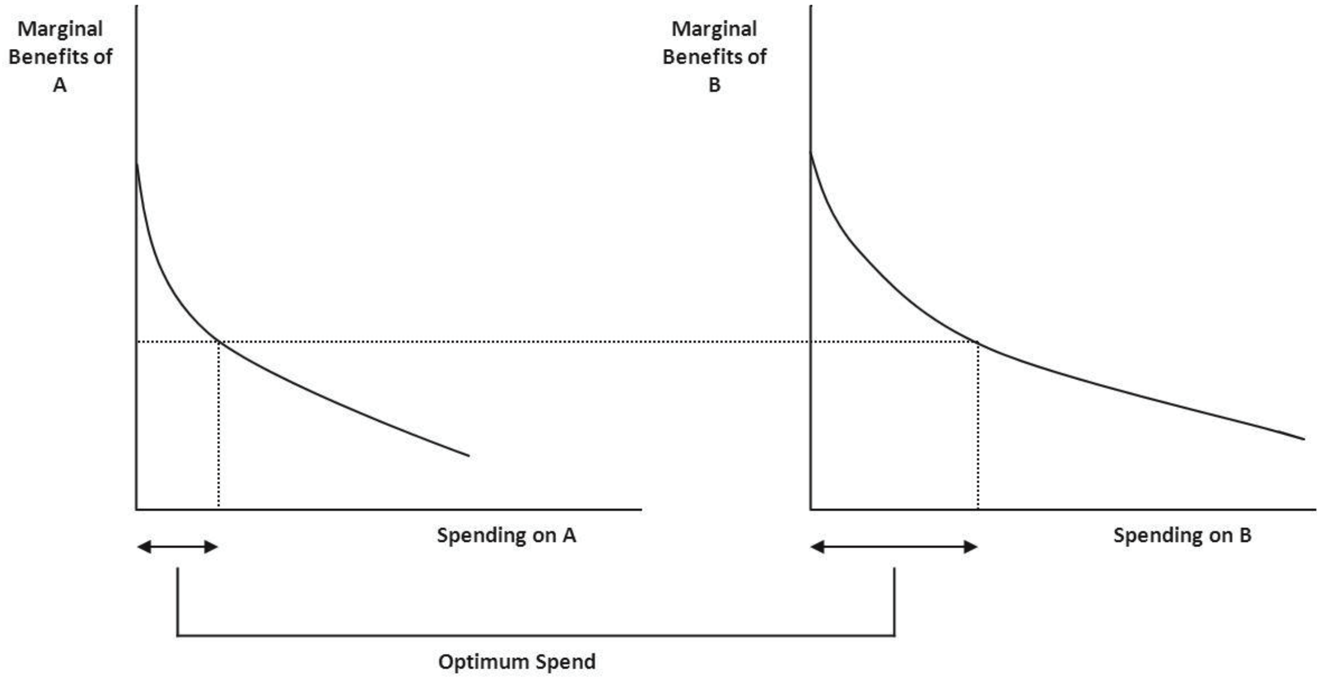
Many of the theories use a form of financial cost benefit analysis where social and economic benefits and costs are compared in financial terms assuming that social costs and benefits can be measured in that way.

(a) Let us now look at different types of budgets to evaluate projects:

Fixed budget

The fixed budget approach suggests that the evaluation is first seen in the context of being given a fixed budget and deciding on the priorities for expenditure. The theory is then similar to that of a household determining its expenditure with a fixed income and knowledge of utilities and marginal utilities of available goods and services and their market prices. There is assumed to be a classical rationality in that the state wished the community to receive the maximum net benefit.

Diagram 3: Variable budgets / marginal



The diagram above shows two potential candidate projects for government expenditure. For each project the marginal benefits are plotted against expenditure incurred.

The curves are based on a view that the marginal or extra benefit of each Shilling spent falls.

On this basis a state that wished to maximise the net benefit of its spending available will allocate outlays so as to equate the marginal benefits of the candidate projects for spending.

The objective of the state is to maximise net benefits.

(b) Let us now look at how expenditure evaluation is affected by the nature of projects and the complexity in objectives before using the marginal theory as a general theory.

(i) Divisible projects

Divisible projects are those where the government can spend any amount of money to finance the project. The amount of the spending could be anything from one Shillings to a billion and one Shillings. With divisible projects the marginal theory can be easily applied since any amount can be allocated to a project such that expenditures can be allocated in proportion to the marginal benefits of the projects. A proposal to spend hours of caring support in hospital wards could be seen as examples of relatively divisible projects.

(ii) Lumpy projects

Lumpy projects are quite different. The projects have relatively stepped costs. Road building projects are of this type since these projects may have outlays that are either spent or not spent. The outlays are indivisible and cannot be spent shilling by shilling.

Some argue that the projects should be ranked or put in order of their net benefit to cost ratio giving a measure of return per shilling spent. The projects with the highest return to spend should be undertaken until the budget has been spent.

Example

Following is the information relating to three projects which are being evaluated by a local government.

Project	Cost	Benefit
Road A	Tshs 80m	Tshs
Road B	Tshs 100m	Tshs
Road C	Tshs 120m	Tshs

Required:

Using the above information, evaluate the project expenditure and choose the most efficient projects if the local government follows:

(a) Fixed budget

(b) Variable budget (c) Divisible projects (d) Lumpy projects

Answer

(a) Fixed budget

To make the expenditure allocation the state should rank the projects by their benefit to cost ratio and undertake each project until the budget is spent. So if the budget was fixed at Tshs200 million only projects A and C would be undertaken. The table below explains the evaluation made.

	C	Ben	Net	Benefit	R
	Ts	Tsh	Tsh		1
	Tsh	Tsh	Tsh	2.6	3
	Tsh	Tsh	Tsh	4	2

Variable budget

Where there is a variable budget the state sector and its constituent parts have to extend their view of the opportunity cost of projects from merely comparing public sector projects against one another to consider the opportunity cost of increasing the state expenditure budget and creating opportunity costs to the private sector as a result.

Divisible projects

In theory we need to add private sector projects into the analysis so that the marginal benefits of all projects are considered.

Lumpy projects

Again in theory we need to add private sector projects into the mix.

9. Issues And Challenges Relating To Government Expenditure

1. **Issues relating to public expenditure**:

(i) Spending to be in accordance with key strategic government objectives such as the MKUKTA strategic interventions in Tanzania.

Example

MKUKTA has at its heart the fundamental objectives of economic growth and poverty reduction. The Tanzanian government has to carefully balance capital spending on infrastructure and current spending on purchases, wages and salaries and services. Whilst current spending provides instant social support it does not build infrastructure such as transport, communications and energy that may be essential in supporting longer-term economic growth. Current spending may however include vital maintenance work on existing infrastructure to maintain its effectiveness thereby supporting economic growth.

(ii) Making spending decisions as part of overall decisions on budgetary stimulation or restraint using
Keynesian fiscal policy tools.

Remember that in times of unemployment we may seek to use a budget deficit to stimulate demand. The amount of deficit is as important as the nature of spending in terms of its multiplier effect. For Tanzania, this is complicated by its reliance on overseas aid. Government spending decisions cannot be entirely separated from fiscal policy decisions.

After the global banking crisis and ensuing recessionary impact, Tanzania has had to use a fiscal stimulus to support economic stability and employment. Exiting from the stimulus inevitably means some expenditure reductions.

(iii) Supporting a scale of public sector activity that involves maintenance and expansion of spending on goods and services or wages and salaries, which in turn will maintain or enhance public sector service provision.

Example

Many areas of public service provision such as social support, health and education are not easily reversible. In the context of Tanzania, poverty reduction is a major spending objective and such expenditure is a long term commitment that may require incremental expansion.

Key sectors in Tanzania are:

Education
Health
Water
Roads
Agriculture
Energy

(iv) Continuing to fund subsidies that may be almost committed to support enterprise activity i.e.
essential public spending on the **provision of goods and services at a reasonable price.**

(v) Having **to support agriculture, transport, water and energy**.

(vi) Having to **spend on social security** to a greater or lesser extent **depending on how economic fluctuations affect payments to the unemployed and families** requiring support. This issue is however more relevant to advanced economies in which transfer payments of social security support are a significant part of the budget.

(vii) Accepting that an **ageing population requires support** as does a **substantial child population** element.

(viii) Being burdened by **past government deficits** that have driven up borrowing and borrowing costs and payments for interest and repayments of capital

Therefore we can conclude that government spending discretion is limited since much is already committed and in place.

2. Challenges relating to public expenditure

The challenges can be seen as:

(a) Finding sufficient sources of funding as revenue to support current levels of capital and revenue spending

(b) Making difficult decisions to achieve priorities

(c) Ensuring long-term economic growth is being supported

(d) Making decisions in a challenging environment where election and re-election are important

(e) Making compromises with political alliances, and coalitions being important to maintain

(f) Dealing with sometimes powerful stakeholder groups such as public sector workers who may resist change and act in self-interest to expand the sector and sector remuneration

(g) The fundamental problem of only being able to make relatively marginal or incremental changes in public spending

Self-Examination Questions

Question 1

'In Tanzania, discretion on government spending is limited'.

Required:

Justify the above statement.

Question 2

The Tanzanian government has a fixed budget of Tshs3.6 million to invest in seven different infrastructure facilities. The cost of each project is represented by its required investment amount. The benefit assessment gives the total benefit for each project. Refer to the table below for details:

Project	Present value of benefits	Present value of investment cost	Net benefits
	Tshs	Tshs	**Tshs**
A	430,000	140,000	290,000
B	360,000	230,000	130,000
C	600,000	420,000	180,000
D	380,000	340,000	40,000
E	1,130,000	870,000	260,000
F	1,440,000	860,000	580,000
G	1,370,000	570,000	800,000
	5,710,000	3,430,000	2,280,000

Required:

Based on the information provided above, determine the projects to be selected and the net benefits from the projects selected.

Question 3
Describe the role of budgeting as a public sector expenditure management tool.

Question 4
Increase in public expenditure is not a new phenomenon. Factors contributing to the tendency of increasing public expenditure are explained in economics by two prominent theories.
Required
State the two theories, and briefly explain what is propounded in each theory.

Question 5
Since its independence Tanzania had experienced an increasing trend of its public expenditure without corresponding increases of public revenues leading to a high public debt. Discuss the factors which have led to this trend overtime.

Question 6
How would you consider the applicability of the Wagner's law of increasing public expenditure in today's modernized world?

Question 7
Public expenditure management is a key policy instrument for influencing on how public resource are allocated and used towards realizing public policy goals, namely: growth, stability and equity, and poverty reduction. Tanzania Public Expenditure Management (PEM) system had been assessed by various institutions worldwide including IMF and the World Bank and found to have multiple failures and few areas that need improvement.
Required:
Describe ways on how Tanzania public expenditure management systems can be improved.

Question 8
Under the current regime in power, Tanzania has witnessed major government efforts to reduce government expenditure by employing some measures including banning public servant foreign travels, postponing of public holiday celebrations and the like and at the same time strengthening public spending in education, health sector and road construction. However, under public expenditure policy there are predetermined principles of public expenditure;
Required:
Explain main principles of public expenditure.

Question 9
Identify tools that can be used by a government to achieve efficient public expenditure management.

Answer to Self-Examination Questions

Answer to SEQ 1

- Spending in accordance with key strategic government objectives such as the MKUKTA strategic interventions. Therefore the Tanzanian government has to carefully balance capital spending on infrastructure and current spending on purchases, wages and salaries and services. Current spending provides instant social support it does not build infrastructure

- Making spending decisions as part of overall decisions on budgetary stimulation or restraint using Keynesian fiscal policy tools. This means that government spending decisions are not independent of fiscal policy decisions.

- Supporting a scale of public sector activity that involves maintenance and expansion of spending on goods and services or wages and salaries, which in turn will maintain or enhance public sector service provision. In the context of Tanzania poverty reduction is a major spending objective and such expenditure is a long term commitment that may require incremental expansion.

- Funding subsidies that may be almost committed to incur public spending on the provision of goods and services at a reasonable price.

- Incurring expenditure in the area of agriculture, transport, water , energy, social security expenditure like health of children and aged

Answer to SEQ 2

In dealing with the case above, one can consider those infrastructure projects which will have a higher ranking in terms of benefits to cost analysis and also will fit into the fixed budget. Refer to the table below to perform the ranking.

Project	resent value of benefits	Present value of	Net benefits	B/C Ratio	B/C ranking
	Tshs	Tshs	Tshs		
A	430,000	140,000	290,000	2.1	1
B	360,000	230,000	130,000	0.6	4
C	600,000	420,000	180,000	0.4	5
D	380,000	340,000	40,000	0.1	7
E	1,130,000	870,000	260,000	0.3	6
F	1,440,000	860,000	580,000	0.7	3
G	1,370,000	570,000	800,000	1.4	2

Based on the rankings determined in the last column of the table, Projects A, G, F and B should be chosen. The total present value of investment cost in these 4 projects is Tshs1.8 million and the present value of benefits is Tshs1.8 million.

The net benefit of these four projects is therefore
Tshs1.8 million.

Answer to SEQ 3

The role of budgeting as a public sector expenditure management tool is as follows:

1. **Accuracy in budget preparation**
   Budget planning and preparation is very critical to good public expenditure management. While formulating a budget, it is **necessary to obtain consistent and reliable data on past public expenditures** in order to budget for the current period**. Past experience should be taken into account** so that past errors may be rectified.

A number of other factors need to be taken into account to ensure a sound budget:

(a) Completeness of coverage of all expected expenditure
(b) Usage of realistic and reasonable assumptions
(c) Usage of realistic projections for expected revenue
(d) Inclusion of provision for change in costs
(e) Inclusion of provision to meet unexpected expenditures

It is necessary to ensure proper control over total expenditure and minimise the cost of budget management.
Productive efficiency and efficient allocation of resources also helps in public expenditure management.

Disclosure of all relevant public revenue and expenditure information is important for accountability of government and to reduce corruption.

Public participation in the budget process for a pre-defined part will also help in better accountability and transparency.

Priority areas need to be identified at the time of budget preparation itself so that funds are not spent excessively on non- priority areas. It is also necessary that proper classification is made between implementing agency (administrative function), purpose of expenditure (functional classification) and use of expenditure (economic classification).

2. **Budget Execution**
   Once the budget is approved at the Central Government level, the responsibility of execution generally lies with the ministries and other appointed agencies. The ministries should ensure that they adhere to the spending limits laid down by the Central Government and regularly report to the government.

Monitoring is generally done at the central level on an aggregate basis and appropriate responsibility should be placed for the monitoring. It is necessary for the Ministry of Finance to ensure that it obtains reliable data on expenditure from the executing agencies at regular intervals and analyse it effectively. This will help in overall control of expenditure. Factors that are important in budget execution are whether the targets are likely to be met and whether the expenditure is likely to exceed budgets. It is important that the monitoring process is such that expenditure incurred will be within the budgeted amount and appropriate measures, if required, are taken to control expenditure.

Answer to SEQ 4

Two theories (or laws) which explain the tendency of increasing public expenditure:

(i)Wagner's laws of increasing state activities

(ii) Wiseman-Peacock Hypothesis

Wagner's law of increasing state activities

- According to this theory, there are inherent tendencies for the activities of different layers of a government such as central and local governments to increase both intensively and extensively.
- There is functional relationship between growth of an economy and government activities.
- The following reasons support inherent long-term tendency of increasing public expenditure
  - Expansion in the traditional functions of the government
  - Growing population
  - The size and nature of public services
  - The need to provide an expand public goods
  - Price tendency (of going up)
  - Etc.

Wiseman-Peacock Hypothesis

- According to this hypothesis, public expenditure does not increase in a smooth and continuous manner, but in jerks or steplike fashion.
- That is, at times, social or other disturbances take place, creating a need for increased public expenditure which the existing public revenue cannot meet.

- Hence, the government is forced to increase field of activities with corresponding increase in public expenditure.

Answer to SEQ 5

Candidates are expected to give the following or similar points:

- Inflation: which reduces current purchasing power
- Public debt: which requires continuous servicing
- Tax revenue: whose increase tends to increase government spending
- Population growth or other demographic variables: which have a bearing on the demand for government services
- Economic growth: which tends to influence the demand for government services
- Foreign aid
- Trade openness
- Geographical distributions by political bonded (The list is not exhaustive)

Answer to SEQ 6

- Wagner, in his law of rising public expenditures', hypothesized that with the development of industrial societies there would be an inevitable and increasing public pressure and political 'pressure for social progress' and an increasing demand for 'social considerations' in business conduct.
- Evidence in the late nineteenth and twentieth century supports this view as many economies were on the developing stage.
- However in the current century this statement does not hold good for developed economies as fiscal restraint is used to tackle with high government borrowings and also fiscal flexibility is used when economies inevitably turn down at times.

Answer to SEQ 7

Ways on how Tanzania public expenditure management (PEM) system can be improved includes:

- ✓ Capacity building to staff involving in PEM
- ✓ Strengthening external audit functions
- ✓ Controlling accumulation of new arrears by enforcing a commitment control system
- ✓ Developing and empowering internal audit functions in a systematic manner
- ✓ Strengthening the fiscal reporting system
- ✓ Enhancing accountability and transparency

Answer to SEQ 8

Main Principles of Public expenditure

(i) **Maximum Social Benefit:** It is necessary that all public expenditure is utilised for general welfare of society at large and not for the benefit of a particular section of the society.

(ii) **Economy:** Public expenditure has to ensure economy that means all wasteful and unprofitable expenditure has to be avoided and that it has to ensure that the tax-payer is not burdened to the extent that savings are affected.

(iii) **Approved expenditure:** It is necessary to ensure that public expenditure is approved by a competent authority and that funds are used for the purpose for which they are approved.

(i) **Flexibility:** It is necessary that an element of flexibility exists so that expenditure can be varied according to needs and circumstances.

Answer to SEQ 9

Tools that can be used by the government to achieve efficient public expenditure management

- Accuracy in budget preparation
- Budget execution
- Cash planning
- Well-defined expenditure policies
- Information on public revenue
- Public expenditure tracking
- Accounting
- Audit

SECTION A

PUBLIC FINANCE AND NATIONAL INCOME

A5

STUDY GUIDE A5: GOVERNMENT BUDGET

Get Through Intro

What do you do when you receive your pocket money? Do you spend the entire amount on the same day? No, you understand that the money that you have received today is to finance your needs for the entire month. So you make a plan of how you are going to spend the money. You ascertain how much money you need to keep aside for necessary expenses like purchasing books, travelling cost, canteen bills etc. You also decide how much you can afford to spend on entertainment like discos and movies. Sometimes, you want to save some amount from your pocket money each month so that after a few months, you can buy an expensive bike for yourself.

This process is budget. Budgeting is the process of creating a plan to spend your money. This plan helps you to determine in advance whether you will have enough money to do the things you need to do or would like to do. If the money that you have is not sufficient to do everything you would like to do, then you need to prioritise and spend your money on the things that are most important to you.

This is the process every individual, every family, every organisation and even every country needs to do - balancing the expenses with the income. This process is important because if you spend more than what you get, you will slowly sink deeper into debt.

In this chapter, we will learn about government budget – the meaning of government budget, the various types of budget, how the money collected from the public is allocated to different expenses according to different priorities etc.

Learning Outcomes

a) Explain the meaning of government budget and describe the various types of a national budget
b) Discuss the approaches for financing of government budget deficit
c) Explain the bases of government budget
d) Explain objectives and functions of a national budget
e) Describe government budgeting process in Tanzania
f) Explain techniques used in preparing national budgets

Explain the meaning of government budget and describe the various types of a national budget; discuss the approaches for financing of government budget deficit; explain the bases of government budget.

[Learning Outcome a, b, c]

1. Meaning of Government Budget and Describe the Various Types of a National Budget

1.1 Meaning

Government budget, in simple terms, means the economic document which contains the forecast by a government of its expenditures and revenues for a specific period of time. A budget usually covers a period of one year, known as a financial or fiscal year, which may or may not correspond with the calendar year.

1.2 **Types of budget**

Budgets can be broadly divided into three types as:

1. Balanced budget
2. Deficit budget
3. Surplus budget

1. Balanced budget

When the total revenue that a government collects in a year is equal to the amount it plans to spend on providing public goods and services and debt interest, it is called a balanced budget. The traditional economists advocated the principle of the balanced budget. Like an individual or a family, the government is also expected to be prudent and not spend more than its income/revenue.

However, modern economists have a different view. It is argued that a government budget is different from a private budget both in terms of its objectives and designs. The aim of a government budget is to maximise the social gain and this objective may not be achieved with a balanced budget.

Also, a balanced budget does not necessarily guarantee the non-existence of uneconomical /unnecessary expenditure.

For instance, if an on-going project is stopped midway because of the fact that the expenditure expected in the year on the project is more than what was budgeted for that year, this will result in delaying the overall completion of the project which will increase the cost of the project. This is detrimental to the economic development of a country.

2. Deficit budget

A budget deficit is a situation when the expenditure is more than the revenues of the government. Thus, there is a shortfall of funds to finance the expenses, which needs to be made good by borrowing.

Some economists criticise the deficit budget on the following grounds:

(a) It is likely to result in increasing the money supply which may further result in creating inflationary pressure in the economy. This causes a fall in the value of money and creates social and economic disturbance in the country.

(b) There is a threat of increased expenditure by the government when the ideology of deficit budget is accepted in the country.

However, some economists support the deficit budget policy on the ground that increased government expenditure helps in creating accelerated income flow in the economy which boosts the demand for the goods and services of the household sector. This leads to a healthier economy

3. **Surplus budget**

   The opposite of deficit budget is surplus budget. When the revenue generated by the Government is more than the public expenditure, it is a situation of surplus budget. In simple words, budget surplus is the saving of the Government. Some economists praise the surplus budget as a surplus is considered a sign that the government is being run efficiently. A surplus budget enables the government to use the funds to pay off the national debt or to make improvements in the public services such as creating more employment opportunities, construction of roads, good education, affordable healthcare facilities etc.

2. Approaches For Financing of Government Budget Deficit

A budget deficit is when a country's government spends more than what it collects from the public in the form of taxes and duties. Individuals, families, companies and other organisations all make budgets. So, sometime or the other, they all experience situations of surplus and deficit. In situations of deficit, the deficit is financed through short or long term borrowings. However, although the borrowing fulfils the immediate need for funds, it is costly as interest needs to be paid on the borrowed funds. Also, the repayment terms need to be strictly observed, otherwise the creditors will come calling. Also, non repayment of the borrowed funds results in losing the credibility of the person or the organisation, which makes further borrowing difficult and expensive.

The same philosophy applies to the government, when its budget runs into deficit. Deficit budget is not uncommon; most governments can run moderate deficits for years. However, there are consequences of budget deficit even for the government, although the consequences aren't immediate. Therefore, sooner or later, the government needs to find out ways to finance the budget deficit.

The various methods of financing a deficit budget are discussed as follows:

- Financing a deficit through borrowing from the country’s central bank: This form of borrowing from the central bank basically means that the government prints money to finance the deficit.
- Financing a deficit through borrowing from the other sectors of the economy such as household sector, business sector and financial sector by selling government securities such as treasury bonds.
- Financing a deficit by increasing the tax rates. Higher tax rates would earn higher revenue for the government.
- Financing a deficit through borrowing from international financial markets or World Bank.
- Financing a deficit by selling government assets. However, this form of financing is not sustainable and can only be used on a ‘one off’ basis.

3. Bases of Government Budget

Government budget is prepared based on different approaches or bases as discussed below:

(a) Legal basis

The legal basis comprises of the following:

- various laws governing the preparation of the government budgets
- administrative regulations concerned with the regulation of the format of the budgets
- formal allocation of rights and responsibilities of various entities involved in the budget cycle

In Tanzania, the following legal provisions act as guidelines for preparing the national budget:

i) **The Constitution of the United Republic of Tanzania of 1977 (as amended from time to time)**: this includes the provisions relating to the finances of the United Republic of Tanzania (URT). This indicates as to who has the mandate of preparing the national budget and submitting the same to the Parliament, permissible categories of revenue receipts, points of authorisation of payments, etc.

ii) **The Public Finance Act of 2004**: this outlines the legal framework within which the country's budget should be drawn up, including provisions relating to revenue, control of expenditures and parties accountable for the budget.

iii) **(The Annual Appropriation Act:** this Act gives the required powers to the Finance Minister to draw and allocate funds from the Consolidated Fund to various votes and also provides for the ways in which funds can be reallocated between votes.

iv) **The Annual Finance Act:** this provides the required powers to the Finance Minister decide upon collecting revenues from the public by means of taxation.

(b) Legislative basis

The role played by the Government in formulating rules and regulations which govern budget preparation, authorisation, execution and control is what forms the legislative base. The National Assembly which is responsible for overseeing the legislative aspects of budgeting in Tanzania consists of:

(i) Parliamentary Standing Committee
(ii) Budget Committee
(iii) Finance, Economic and Industrial development Committee
(iv) local Authorities Accounts Committee (LAAC)
(v) Public Accounts Committee (PAC)

(c) Political base

Ruling party election manifesto, which is the contractual document setting out the agreement between the ruling political party and the voters, is taken into account when the Government budget is prepared to ensure that the promises and commitments made to the voters are implemented.

(d) Economic base

Consideration of tax payer's ability to contribute towards Government revenue is the paramount factor when considering realistic budget preparation. In doing so, the incorporation of various economic variables in the determination of the economic ability to pay is considered.

(e) Administrative base

The budget administration process is divided into the following:

(i) The cabinet It is the cabinet which approves the government budget in principle through the appropriate cabinet economic committee.

(ii) Central ministries

This includes the Treasury planning, Planning Commission, Public service Management, Presidential Bureau and Prime Ministers' Office. They issue budget instructions to coordinate budget preparation across all ministries, regions, independent departments and executive agency.

(iii) Sectorial ministries

These include regions, independent departments and executive agencies where they have the authority to identify programmes, prepare and submit the budget to central ministries, implement the budget and be accountable by preparing reports submitted to the central ministries.

Explain objectives and functions of a national budget; describe government budgeting process in Tanzania; explain techniques used in preparing national budgets.

[Learning outcome c, d, and e]

4. Objectives and Functions of a National Budget

A government budget has the following objectives:

i) To assist policy makers of a nation to develop policies that will lead the nation to achieve its main objectives.
ii) To estimate the total income of the government to support its expenditure plans and developments.
iii) To give authority to future spending; it is a means of authorising expenditure.
iv) To provide a mechanism to control the nation's revenue and expenditure.
v) To set standards to enable performance to be monitored and evaluated.
vi) To serve as a motivating method for both government employees and departmental managers.
vii) To bring together the separate subsystems of the nation to enable them to work together towards the achievement of the objectives of the nation.

Functions of a Budget

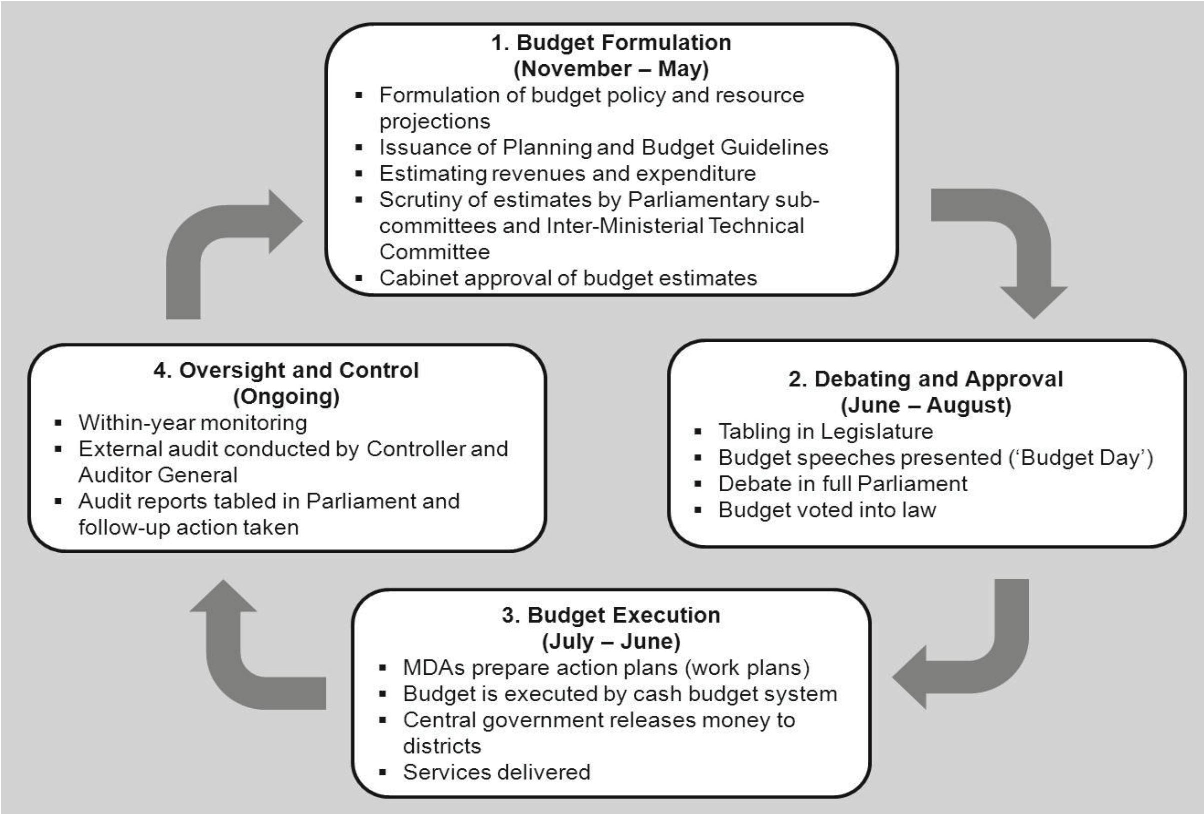
(i) To redistribute incomes: Through a budget the government can redistribute incomes by increasing expenditures in social services and providing subsidies to the small scale businesses.
(ii) To correct a deficit in the balance of payments: Through the budget the government can discourage imports and correct a deficit in the balance of payment by increasing import duty.
(iii) To control inflation: Through the budget the government can control demand pull inflation by increasing direct tax to reduce the purchasing power of the people.
(iv) To stimulate employment: The government can stimulate more employment through the budget by increasing expenditures on economic and social services and providing subsidies to sectors which increase the level of employment such as agriculture, also by reducing tax on inputs in order to encourage investments and therefore create jobs.
(v) Economic stabilization: A budget can be used as an instrument of stabilizing the economy, for example during economic recession the government can reduce tax and increase expenditures to stimulate consumption and a create employment.

5. Government Budgeting Process In Tanzania

A **budget process** refers to the process by which governments create and approve a budget.
The budget process comprises stages which feed into one another in a circular process. We can think of four main phases:

1. Budget formulation (Planning how to spend the money)
2. Debating and Approval of the Budget
3. Budget Execution (Spending the money)
4. Oversight and Control

The below diagram explains the budget process:



6. Techniques Used in Preparing National Budgets

Public sector budgeting has been reformed over many years in Tanzania, especially under the Public Financial Management (PFM) programme. This has led to the following types of systems of budgeting:

(a) The traditional budget

This is the initial system of budgeting that was developed and the main objective was to plan how to utilise the financial resources of the nation to control these resource and also to ensure accountability from the stewards, who are the officials who lead in the use of these resources. Two main features of this type of budget are:

(i) Line Item feature

This system classifies the revenue and expenditure by the nature or type of income and expenditure. The normal types of income are tax, loans, grants etc. The budget is prepared after estimating the revenue to be generated through these. The normal expenditure items are materials, travel and transport, salaries, equipment, repairs and maintenance etc.

(ii) Instrumentalism feature

With the instrumentalism feature, the budget for any year is prepared by making adjustments in the form of either increases or decreases in the preceding year's budget figures. The advantage is seen in the way budget authorities are made to make annual reviews of activities and policies. The traditional budget is also known by these two features, i.e. either as the line item budget or the incremental budget.

Advantages

Some of the advantages of the traditional budgeting system are as follows:

- This budget system is simple to prepare
- It is a means of expenditure control
- It ensures that moneys are used only for their assigned purposes, and it ensures the protection of the finances of the organisation.
- Changes can be made in the line items easily.
- It is also easy to make detailed comparisons between budgeted and actual revenues and expenditures.

Disadvantages

Some of the disadvantages of the traditional budgeting system are as follows:

- The budget is concerned more with conforming to legal requirements rather than looking at proper planning and development.
- It stresses on the importance to spend exactly the amount budgeted for a type of expenditure, without being concerned about the achievement.
- It encourages inefficient spending habits by public officers.
- Expenditure items are not scrutinised because of the incrementalism.
- Again, items of expenditure are often not easily taken out of the budget, so inefficient items at times are still spent on.

(b) Performance Budgeting

This budget stresses on the functions, and projects which are undertaken in the budget as against the traditional budget which stresses on inputs, or expenditure items like materials, wages and stationery. The functions and projects refer to the output of the expenditure; hence the budget was known as 'output budget'. For this system of budgeting, the attention is on the general character and relative importance of the work to be done. Attention is centered on the function or activity, and on the accomplishment of the purpose. Requirements are submitted for budget preparation through programme classification, indicating the past activities of the organisation, their costs, the activities to be undertaken during the next year, the results expected and the pattern of responsibilities assignment.

Advantages

The advantages of using performance budgeting includes:

- This budgeting system gives sufficient information since it includes a narrative description of each project and the services provided by the organisation.
- Inputs and outputs are both shown and measured.
- This is a monitoring device since the result of each activity is noted and measured.
- Emphasis is on the activities of the organisation, as well as on controlling costs.

Challenges in implementing performance budgets

The challenges faced in implementing performance budgeting includes:

- Many times entities face difficulty regarding the classification of programmes and the provision of cost data in respect of many activities.
- The process of allocation of cost estimates over the activity or programme elements is challenging
- Availability of suitable personnel for project costing and analysis is difficult another challenge faced by the public sector.
- Most public sector activities are not easily measurable in output terms. Therefore availability of complete date makes the analysis less meaningful.
- The technique dies not focus on long-term objectives of the government, just as the traditional budget.

(c) The Zero-Based Budgeting (ZBB)

The budgeting technique stresses that every item of expenditure needs to be budgeted for, and should be scrutinised and justified as to why such item should be funded in the budget. The technique expects that

organisations should even justify the reasons that they should continue to exist.

The budget by implication tries to discourage wasteful expenditure, and is aimed at ensuring that useless

projects are not undertaken in the government budget. Organisations and personnel are encouraged to do better analysis of their activities of the past and to ensure that only the relevant ones are budgeted for. This type of budgeting follows three main procedures:

(i) Various decision units are identified, which involve clearly defined and measurable objectives of the organisation or units of the organisation and managers or leaders responsible for such objectives. The effects or impacts of the objectives are also clearly noted.

(ii) Decision packages are developed or determined, which refer to the means of achieving the decision units above, in the form of the services to be performed to achieve the decision units, and the relevant costs or the finance for such services.

(iii) The decision packages are reviewed and then ranked in order of priority. Those decision packages that can be applied very efficiently to the relevant decision units are then selected by the authorities or managers responsible for the achievement of the objectives or programmes. The arrangement of the packages in the order of priority can often be subjective.

Advantages

- Items of expenditure are reviewed and justified before they are accepted.
- It is a mark of financial discipline which is imposed on the organisation.
- The process involves all the personnel in the units, departments or organisations, which is commendable, since it enables every person to feel a part of decision making.

Disadvantages

However, this system also has problems:

- The technique requires a lot of time and resources to identify.
- The decision units cannot be developed easily because objectives and outputs of public organisations are not easy to identify and measure clearly.
- The decision packages or programmes cannot be arranged easily in order of priority; such actions are very subjective, and politicians can decide to carry out certain activities even though the activities are very costly and uneconomical.

(d) Planning Programming Budgeting System (PPBS)

The main features of this budgeting technique are identified in the three main words in the concept:

(i) Planning
This involves the development of long range objectives and goals of the public sector institutions. Such goals and objectives are at times prioritised for the purposes of their achievement.

(ii) Programming
Programmes are developed to achieve the objectives or goals as identified under the planning stage. Alternative programmes are identified here and compared.

(iii) Budgeting
This involves placing money values on the programmes, putting together the costing of the programmes and the relevant benefits that would be derived from the programme. Subsequently, a full system is developed and implemented from an integrated set of selected efficient programmes. This is followed by constant monitoring and reviews.

Advantages

- It stresses more on the future, since planning involves looking into the future.
- It enables budget authorities to evaluate programmes to determine their efficiency and effectiveness.
- It encourages constant review of programmes.
- The system prevents programmes that often overlap through departments; similar programmes in different organisations are well coordinated.

Disadvantages

- The long range planning process is often difficult since going deep into the future is very subjective.
- Planning cannot be done well since most of the goals or objectives in the public sector system cannot be physically identified and measured easily.
- The process requires a lot of time, money and personnel who can do good analysis, financially and technically.
- There is also the problem that most public sector outputs cannot be quantified and measured; hence performance cannot be measured easily through such budgeting system

(e) Medium Term Expenditure Framework (MTEF)

MTEF is a practical tool or decision-making mechanism to integrate policy priorities into the annual budget, in a multi-year perspective (3-5 years), for fiscal soundness and effective resource allocation and for operational effectiveness and performance management. MTEF contains:

(i) a macro-economic framework setting out the three years, underlying assumptions and evaluation and the analysis of macro-economic projection for the preceding three years.

(ii) fiscal strategy document setting out the following:

- Government's medium-term financial objectives
- The Government policies for medium term relating to taxation, recurrent expenditure, borrowings, lending and investments and other liabilities.

- The strategies and the economic, social and development priorities of the Government for the next three years.
- An explanation of the financed objectives, strategies, and economic, social and development priorities as well as fiscal measures.

(iii) an expenditure and revenue framework which will set out:

- estimates of aggregate revenue for the Government for each financial year based on pre-determined tax revenue projections
- aggregate expenditure for each of the next three years
- minimum capital expenditure projection in the Government for the next three years

(iv) a consolidated debt statement indicating and describing the fiscal significance of the debt liability and measures to reduce the liability.

Medium Term Expenditure Framework (MTEF) preparation process

The MTEF budget preparation involves the same process as the traditional budget in terms of effort and time, however ceilings are given for 3years and the budget documentation only provides details for the year that the budget is being presented.

Benefits of the MTEF concept

The following are some of the benefits of MTFEF.

(i) It is a system which has helped to solve the problem between what can be afforded by the government, which is given from the top (top down approach) and the needs of the organisation which are presented from the bottom (bottom up approach).

(ii) It gives more and better information, which enhances transparency and accountability.

(iii) It is a decision-making framework for the consideration of different organisational (ministerial and departmental) policies and agreements among them.

(iv) It enables authorities to predict with some certainty the possible funding support from international organisations.

Self-Examination Questions

Question 1

What are the various ways in which the government can use a budget surplus?

Question 2

Explain the risk involved in borrowing money from overseas to finance a deficit budget.

Question 3

Explain how a deficit budget may result in increased interest cost.

Question 4

In some cases, budget makers prefer to operate at a deficit whereby government expenditure is deliberately planned to exceed revenues.

REQUIRED:

(i) What are the advantages of designing a deficit budget over the balanced budget approach?

(ii) State the weaknesses of a deficit budget approach.

(iii) State any two (2) fiscal measures appropriate in addressing government budget deficits.

Question 5

Compare and contrast the balanced, deficit, surplus budgets, and with reasons state which budget policy could the Tanzanian 5th Phase Government follow to meet its development goals.

Question 6

Identify and discuss the role of the major institutions involved in the budgetary process in Tanzania.

Question 7

Discuss any four main factors that need to be taken into account to ensure an effective and sound country's budget.

Question 8

One of the challenges facing developing countries including Tanzania is resting on how to finance their budget deficits. This problem is further compounded by the fact that some alternatives of financing the deficit budget might negatively impact on the country's economy.

Required:

Citing one disadvantage in each case, explain any five measures that a government could undertake to finance a budget deficit.

Question 9

Explain the differences between ''public debt'' and ''government budget deficit ''

Question 10

Explain how deficit spending could be a burden to future generations

Question 11

Since the overall level of employment and prices depend on the level of total demand relative to capacity output, stabilization budget action is needed to maintain stable aggregate demand.

Required:

Explain how stabilization budget actions work during depression and inflation.

Question 12
Experiences show that most less developed countries face deficit budget for a number of decades and they pursue their fiscal policy objectives by partly depending on developed economies.
Required:
Discuss the features of deficit budget using an example of any country of your choice.

Answers to Self-Examination Questions

Answer to SEQ 1
The government can use a budget surplus in various ways as follows:
1. The government can use the surplus to repay the debts taken in previous years to finance previous deficits. This will result in reducing the interest payments. Interest payments saved by the government can then be used to fund other areas of future expenditure.
2. The surplus can be used to fund government expenditure on infrastructure and the purchase of assets.
3. The surplus can also be used to fund tax cuts.

Answer to SEQ 2
Borrowing money from overseas is a common method of deficit financing. However, if the borrowed money is not put to productive use, it will not generate sufficient returns. This, in turn, will result in problems in servicing the debt. And it will ultimately show up in the form of an unstable currency. This will make further borrowing difficult.

Answer to SEQ 3
A deficit budget situation occurs when a government's spending exceeds its income. To bridge the shortfall, the government needs to borrow funds. The increase in borrowing results in increased interest cost. Thus, the higher the debt, the higher is the interest. This may weaken the economy as government revenue is used to pay for finance costs rather than being used for productive purposes.

Answer to SEQ 4
Advantages, weaknesses and measures of/for deficit budget

(i) Advantages
- Help the economy in fighting a depression/may help economy in recovering from a depression
- Can be used to raise the level of economic activities and income
- Since direct saving capacity of the people is limited, it is easier through deficit financing for the purpose of financing the growth of public sector

(ii) Weaknesses of deficit budget over balanced budget
- Deficit budget is usually (must be) financed by borrowing money, hence,
  - Interest must be paid
  - Deficit budget adds to the currency and money supply in the country, thereby adding to/strengthening inflationary pressures
- May give rise to wasteful expenditure, i.e. deficit budgets create inflationary pressures
- With appropriate qualifying conditions, even a balanced budget can raise the level of economic activities and income, provided the size of the budget is increased (hence, deficit budget is less/weakly justifiable)

-

(iii) Measures to address government budget deficit

- Cutting spending
- Raising taxes
- Combination of the two (cutting government expenditure + raising taxes)

Answer to SEQ 5

Balanced budget

When the total revenue that a government collects in a year is equal to the amount it plans to spend on providing public goods and services and debt interest, it is called a balanced budget. The traditional economists advocated the principle of the balanced budget. Like an individual or a family, the government is also expected to be prudent and not spend more than its income/Revenue.However, modern economists have a different view. It is argued that a government budget is different from a private budget both in terms of its objectives and designs. The aim of a government budget is to maximize the social gain and this objective may not be achieved with a uneconomical/unnecessary expenditure. For instance, I an on-going project is stopped midway because of the fact that the expenditure expected in the year on the project which will increase the cost of the project. This is detrimental to the economic development of a country.

Deficit budget

A budget deficit is a situation when the expenditures more than the revenues of the government. Thus, there is a shortfall of funds to finance the expenses, which needs to be made good by borrowing. Some economists criticize the deficit budget on the following grounds.

(a) It is likely to result in increasing the money supply which may further result in creating inflationary pressure in the economy. This causes a fall in the value of money and creates social and economic disturbance in the country.

(b) There is a threat of increased expenditure by the government when the ideology of deficit budget is accepted in the country. However, some economists supported deficit budget policy on the ground that increased government expenditure helps in creating accelerated income flow in the economy which boosts the demand for the good and services of the household sector. This leads to a healthier economy.

Surplus budget

The opposite of deficit budget is surplus budget. When the revenue generated by the Government is more than the public expenditure, it is a situation of surplus budget. In simple words, budget surplus is the saving of the Government.

Some economists praise the surplus budget as a surplus is considered a sigh that the government is being run efficiently. A surplus budget enables the government to use the funds to pay off the national debt or to make improvements in the public services such as creating more employment opportunities, construction of roads, good education, and affordable healthcare facilities etc. Given, low tax compliance level the Government should continue using deficit budget policy otherwise, many projects may not be accomplished.

Answer to SEQ 6

(b) Major Acts in the Tanzania Budgetary Process in public sectors

A number of individuals and public institutions are involved in the annual preparation and implementation of the Tanzania budgetary process in public sectors. The following are the major Actors in the Tanzania budgetary process.

Tanzania Revenue Authority

The Tanzania Revenue Authority (TRA) acts as a central body for the assessment and collection of specified revenue, administers and enforces the laws related to such revenue and provides for related matters of revenue in Tanzania mainland and Zanzibar. The TRA becomes operational in July 1996, replacing the former independent Treasury Departments of Income Tax, Customs, Sales, Inland Revenue and the Institute of Tax Administration.

President and Cabinet

The Cabinet through the Minister for Finance and Economic Affairs (MOFEA) is responsible for presenting the budget before the legislature for approval. The various cabinet ministers also present their respective Sectoral budgets for their Ministries, Departments and Agencies (MDAs) for debate and approval by the legislature. The Cabinet has the responsibility of defending the budget and ensuring that it is passed by the legislature.

Ministry of Finance

The Ministry of Finance plays a central role in the budget process and justifies separate mention. MOF makes projections, sets ceilings for budget allocations, negotiates priorities with all departments, collects revenues, and disburses funds. The Ministry also plays an important controlling function through the Accountant General, who is responsible for ensuring that all financial transactions and reporting is done according to the proper regulations.

Budget Guidelines Committee

The Budget Guideline Committee includes representatives from MOFEA, Public Service Management, and the Prime Minister's Office – Regional Administration & Local Government (PMO-RALG). This committee is responsible for developing the Planning & Budget Guideline.

Donors

Given the sizeable contribution of foreign aid to Tanzania's budget, donors also have an impact on the ways in which the budget is prepared and implemented. Donors (also called development partners or DPs) participate in consultations that inform budget formulation, disburse funds, and monitor public spending and expenditure systems.

Parliament

The main responsibilities of Parliament in relation to the budget process are: securitizing the budget through various standing committees; adopting or rejecting the budget in Parliament, monitoring the implementation of the budget and the performance of the MDAs; and overseeing the use of public funds. Parliament can refuse to adopt the budget presented by the executive, the consequences of this step are profound the President has the constitutional power to dissolve Parliament in response.

Controller and Auditor General

The controller and Auditor General (CAG) is the Audit Institution in Tanzania. The CAG is responsible for, among other things, ensuring that the expenditure of public monies has been properly authorized and applied for the intended purposes. It should also ensure that economy, efficiency and effectiveness have been achieved in the use of public resources. The CAG has extensive powers to subpoena officials and to obtain information. The willful obstruction of the work of the CAG, or failure by any public official to provide the CAG with access to any item of information, constitutes a criminal offence.

Private Sector

In addition to contributing the majority of domestic tax revenue, the private sector plays a consultative role in the budget process. Most notably, the private sector participates actively in an annual consultation on the revenue framework, which occurs before the budget is formulated each year. Their concerns are often taken on board when designing or revising tax policies.

Civil Society

Civil society plays a number of different roles in thebudget process, through its formal role is limited to a consultative one. The formal role of civil society has been participation in the Public Expenditure Review (PER) and related processes. Informal roles include analyzing public budgets, producing simplified and popular versions of the budget and related documents, playing a watchdog role, tracking expenditure at the local level, and advocating for improvements in terms of specific requests and overall transparency and accountability. Civil society's informal roles are arguably more effective, particularly when combined with strategic use of media and citizen engagement.

Answer to SEQ 7

Factors that need to be take into account to ensure a sound budget

(i) Completeness of coverage of all expected expenditure
(ii) Usage of realist and reasonable assumptions

(iii) Usage of realist projections for expected revenue
(iv) Inclusion of provision for change in cost

(v) Inclusion of provision to meet unexpected expenditure
(vi) Involvement of skilled and qualified personnel

Answer to SEQ 8
The various methods of financing a deficit budget are discussed as follows:

(i) **Financing a deficit through borrowing from the country's central bank:**
This form of borrowing from the central bank basically means that the government prints money to finance the deficit. The downward risk of this approach is outshot of inflation rate in the economy.

(ii) **Financing a deficit through borrowing from the other sectors of the economy such as household sector, business sector and financial sector by selling government securities such as treasury bonds:**
This approach reduces many in circulation and may pose difficulties in trading activities in the economy.

(iii) **Financing a deficit by increasing the tax rates:**
Higher tax rates would earn higher revenue for the government at expense of distorting trade levels and increasing likelihood for increased level of tax evasion practices in the economy.

(iv) **Financing a deficit through borrowing from international financial markets or World Bank:**
This is the mostly used source though for developing countries it reduces economic independent of the country as result of complying with loan conditions.

(v) **Financing a deficit by selling government assets:**
However, this form of financing is not sustainable and can only be used on a 'one off' basis.

Answer to SEQ 9
Differences between the public debt and the government budget deficit

✓ Budget deficit is basically the excess of government's total expenditure over total revenue. Total expenditure can be of two types, capital expenditure and revenue expenditure. These are financed out of revenue receipts and capital receipts.

✓ Public debt, which is also sometimes referred to as government debt, is all of the money owed at any given time by any branch of the government. It encompasses debt owed by the federal government, the state government, and even the municipal and local government. Public debt accrues over time when the government spends more money than it collects in taxation. As a government engages in more deficit spending, the amount of debt increases.

Answer to SEQ 10
How budget deficit spending could be a burden to future generations.

✓ Creating additional debt has two negative consequences aside from any intergenerational equity concerns. First, increasing taxes to pay the interest adds to the scale of tax distortions in the economy.

✓ Second, it seems likely that additional government debt will to some extent crowd out investment in productive capital, and this is a cost if, as also seems likely, we currently have less than the optimum amount of productive capital.

Answer to SEQ 11

- During depression, aggregate demand is to be raised through expansionary revenue – expenditure policy.
- In a period of inflation, demand may exceed available output and thus restrictive policy is needed to curtail total expenditure.

Answer to SEQ 12

A candidate is expected to discuss based on the following Features of Deficit Budget:

(i) Low rates of taxes in the economy.
(ii) High rate of investment as low taxes motivates the investors.
(iii) Monetary expansion due to low tax rates.
(iv) Expansion of employment opportunities from more investments
(v) Expansion of aggregate demand due to much money in circulation.

SECTION A

PUBLIC FINANCE AND NATIONAL INCOME

A6

STUDY GUIDE A6: PUBLIC BORROWING AND DEBT

Get Through Intro

The term "public debt" is used interchangeably with the term sovereign debt. Public debt is the accumulation of annual budget deficits. It's the result of years of Government spending more than they take in via tax revenues. Public debt includes Treasury bills, notes, and bonds, which are typically bought by large investors. In the short run, public debt is a good way for countries to get extra funds to invest in their economic growth. Public debt is a safe way for foreigners to invest in a country's growth by buying government bonds.

In this chapter, we will learn about public debt – the meaning, the various classification of public debt, the causes and repayment measures of public debt.

Learning Outcomes

a) Explain the meaning and classification of public debts
b) Discuss the causes, consequences and repayment of public debts
c) Explain the measures that can be used to reduce the burden of debts in Less Developed Countries

Explain the meaning and classification of public debts; discuss the causes, consequences and repayment of public debts; explain the measures that can be used to reduce the burden of debts in Less Developed Countries

[Learning outcome a, b, and c]

1. Meaning and Classification of Public Debts

1.1 The meaning

Public debt is defined as how much a country owes to lenders outside of itself. These can include individuals, businesses, and even other governments. **Classifications of Debts**

Debts can be categorized into the following groups

a) Internal or external debts:

i) Internal Debts

This refers to money owed by the government to institutions/individuals/commercial bank within the country.

ii) External Debts

This refers to money owed by the government to institutions outside the country and donor countries.

b) Long term and short term debts

i) Long Term Public Debts:

These are debts which are repaid after a long period of time, e.g between 5 and 20 years.

ii) Short Term Debts:

These are debts which are repaid after a short period of time.

c) Reproductive and non-reproductive debts:

i) Reproductive Debts

These are debts which a government use the money borrowed for productive expenditures such as construction of roads or provision of social services.

ii) Non-Reproductive Debts

These are the debts which the government use the money borrowed for non-productive expenditures such as buying of arms.

2. Causes, Consequences And Repayment Of Public Debt

2.1 Causes and justification of public debt

Quite often, governments have greatly depended on borrowing and this can be justified by a number of reasons.

i) Inadequate tax revenue. Poor countries incur debts because the revenue collected from taxes is insufficient to finance government programmes. At times, the expected revenue tends to fluctuate.
ii) To reduce the burden of taxation. Borrowing is often resorted to, as a means of reducing the tax burden from the people.
iii) Overcome natural calamities. Debts are also incurred to meet the unexpected occurrences such as floods, drought, etc.
iv) Debt servicing. It is a common practice y some developing national to incur fresh debt in order to repay the old ones.
v) Political instability. The prevailing political turmoil in developing countries (especially in Africa), has greatly necessitated government borrowing thereby incurring public debts.

2.2 Positive Consequences of a Public Debt

A Public debt could have some positive consequences to the country.

i) The debt incurred can lead to an increase in GDP, if it is used appropriately to exploit and mobilize the domestic production for increased output.
ii) More employment prospects can be generated, when the debt is a self-liquidating one (i.e. aimed at stimulating production activities).
iii) A public debt (borrowing) tends to reduce political resistance to high taxation which is likely among the citizens of developing countries.
iv) A public debt can reduce political instability e.g. through borrowing to finance wars. A stable political atmosphere, there is no doubt, can encourage production for development.

2.3 Negative Consequences of a Public Debt

i) The burden falls on the citizens who are taxed to cover an internal debt, so that the size of the debt may influence the level of taxation.

ii) The effect is great on the level of consumption as high taxes on individuals deprive them of consumption.

iii) The future generation is affected as a result of the debt incurred sometime back, to finance services that it never enjoyed.

iv) Debt repayment reduces expenditure on capital goods for investment and thus limited capital formation.

v) A public debt encourages over dependence on external sources, and yet this cannot promote the spirit of self-reliance

vi) The debt incurred (in form of tied aid) is always accompanied with strings (conditions) attached which often conflict with the development programmes of the recipient country.

2.4 Repayment of public debts

This refers to attempts by the government to pay public debts. **Approach to repay public debt**

i) **Refunding**

Refunding of debt implies the issue of new bonds and securities by the government in order to repay the matured loans. In the refunding process, usually short-term securities are replaced by issuing long-term securities. Under this method the money burden of public debt is not relinquished but it is accumulated owing to the postponement of debt redemption.

ii) Conversion

Conversion of public debt implies changing the existing loans, before maturity, into new loans at an advantage in servicing charges. In fact, the process of conversion consists generally, in converting or altering a public debt from a higher to a lower rate of interest. Thus, the obvious advantage of such conversion is that it reduces the burden of interest on the taxpayers. Furthermore, lower interest rates on public loans would means a less unequal distribution of income.

iii) Surplus budgets

Quite often, surplus budgets (i.e. by spending less than the public revenue obtained) may be utilised for clearing off public debts. But in recent years due to ever-increasing public expenditures, surplus budget is a rare phenomenon.

iv) Sinking fund

A sinking fund is a fund created by the government and gradually accumulated every year by setting aside a part of current public revenue in such a way that it would be sufficient to pay off the funded debt at the time of maturity. Perhaps, this is the most systematic and best method of redemption.

v) Negotiation for Debt cancellation

Similarly public debt can be settled through round table negotiation between countries in exchange for future services or as way of providing grant especially in developing countries.

3. Measures That Can Be Used To Reduce The Burden Of Debts In Less Developed Countries

Apart from debt management policies, certain measures can be used to reduce the debt burden in developing nations

i) Self-reliance: LDC's can reduce dependency on foreign debts by boosting domestic production to have a self-reliance economy hence reduce foreign dependency.

ii) Import control measures: The government can apply import control measures such as tariffs to reduce spending on imports which is one of the reasons for increase in foreign debt.

iii) Reduction in government expenditures: The government can reduce expenditures on non-priorities to avoid borrowing of money.

iv) Strengthening of tax collection: The government should increase efforts in tax collection to get enough revenue to finance its expenditures instead of depending on foreign aid.

Self-Examination Questions

Question 1

Government borrowing and debt levels have always been central to fiscal policy but they have rarely been so high profile in both policy discussion and media coverage concerning the economy as they are at present. Given current and projected economic circumstances, this seems likely to remain the case for the foreseeable future.

Required

a) Define the term Public Sector Net Debt.
b) Distinguish between government borrowing and government debt
c) Discuss how traditional Keynesian theory expected government borrowing to behave over the life of an economic cycle.

Question 2

Public debt enables governments to invest in critical areas of the economy where the capacity of tax revenue to undertake these projects may be limited or in situations where printing additional money will disrupt the stability of the economy. It permits an equitable alignment of benefits and costs for long-gestation projects by shifting taxation away from current generations.

Required:

i) What is public debt?
ii) Critically examine Public debt as an alternative to Taxation and its effect on the economy.

Question 3

The current level of government borrowing has become a topical issue for discussion causing observers to wonder whether borrowing is good or bad.

Required

Evaluate the effect of government borrowing on the economy of Tanzania.

Question 4

Explain the differences between the 'public debt' and government budget deficit.

Question 5

Briefly describe recommended approaches in retiring a public debt.

Question 6

With public sector debt increasing around the world, an important issue to consider is how much can a country borrow.

Required:

Discuss four factors which determine the borrowing level of a country

Question 7

It is evident that most of Less Developed Countries (LDC) are facing persistent increase in public debts from their counterpart developed countries. However, there is a contention that it is not whether these countries are indebted or not rather it is how these debts were utilized by the recipient countries.

Required:

By your own views, discuss this contention.

Answers to Self-Examination Questions

Answer to SEQ 1

(a) Public Sector Net Debt is the total consolidated debt of all branches of government minus the amount of short-term liquid assets held by the public sector.

(b) **Borrowing** represents a flow of funds from a borrower to a lender. The government borrows, e.g. from financial institutions, to make up shortfalls between its current revenue and current expenditure. **Debt** is a stock of liabilities generated by past borrowing which have yet to be repaid. Government borrowing in a given period of time will add to its stock of debt.

(c) 'Keynesian' theory refers to the economic theory propounded by John Maynard Keynes, which informed much UK economic policy from 1945 to the 1970. The economic cycle consists of cyclical variations over time in real gross domestic product. Economies experience periods of expansion and contraction in an economic cycle typically lasting several years, although historically on a long term upward trend. Keynes believed that governments should deliberately unbalance their budgets across the economic cycle i.e. in pursuit of an acceptable combination of the following policy objectives:

- full employment
- price stability
- economic growth
- balance of payments health

Much of the above occurred automatically i.e. In economic downturns reduced incomes led to lower tax revenues and increased government expenditure on e.g. social security benefit payments, meaning that the government needed to borrow to make up the shortfall.

The opposite typically occurred in economic upswings as buoyant income increased tax revenues and prosperity e.g. reduced the eligibility for social security payments. In such periods Keynes expected government finances to be in surplus.

Keynes also advocated discretionary policy measures to reinforce such automatic effects across the cycle. For example, tax rates might be reduced in downswings to stimulate economic activity and increased in upswings to help dampen down inflationary pressures.

The theoretical outcome of all this was that government budget deficits in the downturns and surpluses in the upturns would match each other and thus the government budget would broadly balance across the cycle.

Answer to SEQ 2

(i) **Public debt** is defined as how much a country owes to lenders outside of itself. These can include individuals, businesses, and even other governments. The term "public debt" is used interchangeably with the term sovereign debt. Public debt is the accumulation of annual budget deficits. It's the result of years of Government spending more than they take in via tax revenues. **Public debt includes Treasury bills, notes, and bonds, which are typically bought by large investors**. In the short run, public debt is a good way for countries to get extra funds to invest in their economic growth. Public debt is a safe way for foreigners to invest in a country's growth by buying government bonds.

(ii) **Public debt as an alternative to Taxation and its effect on the economy.**

When Public Debt is used as an Alternative to Taxation

- Public borrowing has an important advantage over taxation. Taxation beyond a certain limit tends to affect economic activity adversely owing to its disincentive effect. There is no such danger in public borrowing. It does not have any unfavorable repercussions on economic activity by being disincentive, partly because of its voluntary nature and partly because of expectation of return and repayment.

- Public debts enable governments to facilitate growth take-offs by investing in a critical mass of infrastructural projects and social sectors of the economy where taxation capacity may be limited. Public Debt for financing fruitful investment produces supplementary, creative capability in the financial system which or else would not have been achievable.
- Public Debt also facilitates tax smoothing and counter-cyclical fiscal policies, essential for reducing output volatility; and it permits an equitable alignment of benefits and costs for long-gestation projects by shifting taxation away from current generations.
- Public debt is a safe way for foreigners to invest in a country's growth by buying government bonds. This is much safer than foreign direct investment. That's when foreigners purchase a percentage interest in the country's companies, businesses or real estate. It's also less risky than investing in the country's public companies via its stock market. Public debt is attractive to risk-averse investors since it is backed by the government itself.
- When used correctly, public debt improves the standard of living in a country whilst Taxation increase the cost of living of citizens. That's because it allows the government to build new roads and bridges, improve education and job training, and provide pensions. This spurs citizens to spend more now, instead of saving for retirement, further boosting economic growth.

Consequences of Public Debt on the Economy

- Large public debt implies high interest payments and these are borne by tax payers. Governments have virtually no means of repaying debt other than through future taxation. While there is a multiplier effect to government spending, high levels of government debt essentially saddle future generations with the deadweight loss of higher taxation with no offsetting multiplier to the GDP from government spending.
- Government borrowing increases the total demand for credit in the economy, driving up the cost of borrowing in the process. Higher borrowing costs make it more expensive to finance investment in equipment, stock and other capital goods in the private sector. This increases the cost of doing business in the private sector.
- Currency collapse or currency depreciation when monies are printed to finance public debts.

Answer to SEQ 3
Effects of Public Debt

(i) **Effects on Production**
Public debts are raised to finance productive enterprises of various kinds, e.g., steel works, cement, multipurpose projects, construction of ships, railway lines and highways, heavy electrical and engineering works, mining, oil refining,

(ii) **Effects on Consumption**
When people subscribe to government loans, they generally have to curtail consumption. Since investment of funds raised by borrowing raises the level of employment and as a result raises the level of consumption

(iii) **Effects on Distribution of wealth**
Public loans transfer money from rich to government. The fiscal operations of the government are to benefit the poor primarily. The incomes of the poor increase directly through increased employment or it benefit them in directly through the enlargement of social services.

(iv) **Effects on the Level of Income and Employment**
In modern times, public borrowing is resorted to in order to raise funds for financing agriculture, industry, mining, transportation, communication, etc. It increases employment opportunities, the level of income and standard of living.

Answer to SEQ 4

Differences between the public debt and the government budget deficit.

- Budget deficit is basically the excess of government's total expenditure over total revenue. Total expenditure can be of two types, capital expenditure and revenue expenditure. These are financed out of revenue receipts and capital receipts.
- Public debt, which is also sometimes referred to as government debt, is all of the money owed at any given time by any branch of the government. It encompasses debt owed by the federal government, the state government, and even the municipal and local government. Public debt accrues over time when the government spends more money than it collects in taxation. As a government engages in more deficit spending, the amount of debt increases.

Answer to SEQ 5

Recommended approaches in retiring a public debt:

- Repudiating (rejecting) the debt
- Create a sinking fund
- Surplus budgets
- Conversion

Answer to SEQ 6

Factors which influence how much a government can borrow:

- **Domestic savings**
  If consumers have a high savings ratio, there will be a greater ability for the private sector to buy bonds. With high domestic savings there has been a willingness by the private sector to buy the government debt.

- **Relative interest rates**
  If government bonds pay a relatively high interest rate compared to other investments, then *ceteris paribus*, it should be easier for the government to borrow. Sometimes, the government can borrow large amounts, even with low interest rates because government bonds are seen as more attractive than other investments.

- **Lender of last resort**
  If a country has a Central Bank willing to buy bonds in case of a liquidity shortages, investors are less likely to fear a liquidity shortage. If there is no lender of last resort, then markets have a greater fear of liquidity shortages and so are more reluctant to buy bonds.

- **Prospects for Economic Growth**
  If one country faces prospect of recession, then tax revenues will fall, the debt to GDP ratio will rise. Markets will be much more reluctant to buy bonds. If there is forecast for higher growth. This will make it much easier to reduce debt to GDP ratios. The irony is that cutting government spending to reduce deficits, can lead to lower economic growth and increase debt to GDP ratios.

- **Confidence and Security**
  Usually, governments are seen as a safe investment. Many governments have never defaulted on debt payments so people are willing to buy bonds because at least they are safe. However, if investors feel a government is too stretched and could default, then it will be more difficult to borrow. Therefore, some countries like Argentina with bad credit histories would find it more difficult to borrow more. Political uncertainty can make investors more concerned.

- **Inflation**
  Financing the debt by increasing the money supply is risky because of the inflationary effect. Inflation reduces the real value of the government debt, but, that means people will be less willing to hold government bonds. Inflation will require higher interest rates to attract people to keep bonds. In theory, the government can print money to reduce the real value of debt; but

existing savers will lose out. If the government creates inflations, it will be more difficult to attract savings in the future.

Answer to SEQ 7

A candidate is expected to explain the meaning of public debt and explicitly show whether all debts are burden to future generations.

The discussion should capture the following:

It depends on what the government spends the money on. If the government borrows money and then invests it in productive assets – building or repairing infrastructure, researching new ideas, improving schools, roads, bridges, electrical grids and broadband infrastructure, - and if those productive assets have real rates of return that exceed the rate at which the government borrowed, then the debt (or rather, the debt-financed spending) transferred consumption from us to our descendants, not the other way around. And note that this is true whether the government borrows domestically or from foreigners. But if the government spends the money on consumption – for example, buying everyone in the country a birthday cake – then the debt-financed spending has transferred consumption from our descendants to us and it has imposed a burden on future generations. That means, if our government borrows to invest in those things, it will be doing our grandkids a favour, not imposing a burden.

Therefore to conclude; the size of government debt is not a good indicator of any burden. It is possible that government debt is positive, but there has been no attempt at intergenerational transfer due to the following reasons:

- Taxes on the young are cut, and the young save all the tax cut by holding the extra debt.

- Borrowing for a capital project that benefits current and all future generations equally.

SECTION A

PUBLIC FINANCE AND NATIONAL INCOME

A7

STUDY GUIDE A7: FISCAL POLICY

Get Through Intro

When policymakers seek to influence the economy, they have two main tools at their disposal—**monetary policy** and **fiscal policy.** Central banks indirectly target activity by influencing the money supply through adjustments to interest rates, bank reserve requirements, and the sale of government securities and foreign exchange; governments influence the economy by changing the level and types of taxes, the extent and composition of spending, and the degree and form of borrowing. In this chapter, we will learn about fiscal policies – the meaning and objectives, tools of fiscal policy and problem in using fiscal policies.

Learning Outcomes

a) Explain the meaning and objectives of fiscal policy
b) Describe tools/mechanisms of fiscal policy
c) Describe Forms of fiscal policy
d) Describe problems in using fiscal policy

Explain the meaning and objectives of fiscal policy, describe tools/mechanisms of fiscal policy.

[Learning Outcome a and b]

1. Meaning And Objectives Of Fiscal Policy

The meaning of fiscal policies

Is any change in government spending and taxation that is designed to change overall spending in an economy. The use of government spending and taxation to influence economic growth/Any action taken by the government which influences the timing, magnitude and structure of current revenue and expenditure.

Objectives of fiscal policies

(i) To achieve full employment
Fiscal policy aim to reduce unemployment

(ii) Price stability
However lowering expenditure is not advisable in less developed countries to fight inflation. So also an increase in taxation may not be possible as taxable capacity is low. Hence in time of inflation, fiscal policy should be supplemented by monetary policy to control inflation.

(iii) To accelerate the rate of economic growth
Taxation, government expenditure and public borrowings should be used to encourage consumption, production and distribution.

2. Tools/Mechanisms Of Fiscal Policy

Tools of Fiscal Policy

The followings are the tools of fiscal policy.

(i) Government expenditures.
(ii) Taxation.
(iii) Borrowings.

Mechanisms/types of Fiscal Policy

There are two mechanisms of fiscal policy

(i) Expansionary fiscal policy
(ii) Contractionary fiscal policy

(i) Expansionary Fiscal Policy

In this policy the government increases its expenditures and reduces the amount of tax in an attempt to increase aggregate demand. Expansionary fiscal policy is designed to influence aggregate demand since when expenditures are increased on things such as education, health, road construction, salary to civil servants it results to an increase in incomes to the people which act as a stimulant to aggregate demand. When the economy is in a contraction or recession, the government will enact an **EXPANSIONARY FISCAL POLICY** to "expand" the economy. **There**

by increasing GDP, disposable income and lowering unemployment. A result of this policy is an increase in the price level. This will increase the aggregate demand by doing the following:

i) Decreasing Taxes (more money in people's pockets)
ii) Increasing Transfer Payments (more money in people's pockets)
iii) Increase Government Spending on social programs (more money in people's pockets

(ii) Contractionary Fiscal Policy

This is a policy in which the government attempts to reduce aggregate demand by increasing tax and reducing expenditures. The aim is to control inflation. When the economy is in an expansion which results in high prices, the government will enact a contractionary fiscal policy to "contract" the economy. There by decreasing GDP and increasing unemployment. a result of this policy is a decrease in the price level. Remember that fiscal policy is a tool to help stabilize prices and control unemployment. Since unemployment is linked to GDP, it is possible that when the government enacts a contractionary policy to decrease aggregate demand, that unemployment is going to increase. However, mild unemployment is better than hyperinflation. This will decrease the aggregate demand by doing the following.

- Increasing taxes (less money in people's pockets)
- Decreasing transfer payments (less money in people's pockets)
- Decrease government spending (less money in people's pockets)

Describe Forms of fiscal policy, and describe problems in using fiscal policy

[Learning Outcome c and d]

3. Forms Of Fiscal Policy

There are 2 forms of fiscal policy

(i) Discretionary Fiscal Policy

The discretionary changes in government expenditures and/or taxes in order to achieve certain national economic goals which are the realm of fiscal policy.

(i) High employment (low unemployment)
(ii) Price stability
(iii) Economic growth
(iv) Improvement of international payments balance

Discretionary fiscal policy involves changes in the government which is designed to change level of real gross domestic product (GDP), unemployment, income or price level. Specific actions are needed in a discretionary fiscal policy that involves changes in government spending (increasing/decreasing) and taxation (increasing/decreasing tax rates).

(ii) Automatic or Built-In Stabilizers (Non Discretionary Fiscal Policy)

Changes in government spending and taxation that occur automatically without deliberate action of government Non-discretionary fiscal policy occurs automatically through built in stabilizers such as progressive tax rates. As Gross Domestic Product (GDP) increases, the average tax rate will increase in progressive tax system. The increases average tax will reduce people’s incomes and hence demand for goods and services

4. Problems In Using Fiscal Policy.

There are several problems in involved in implementing fiscal policy. They include:

1. **Crowding Out Effect**

   When the government increases spending by borrowing money (like with Treasury bonds), that leaves fewer funds available for firms to borrow for investment and for consumers to borrow to purchase goods and services. In others words, the government "crowds out" private investment.

2. **Time Lags**.

   If the government plans to increase spending this can take a long time period to filter into the economy and it may be too late spending plans are only set once a year. It takes time for the government to recognize the need for intervention, to agree on a policy, to implement the policy, and for the policy to start affecting the behavior of consumers and firms. For example, it may take months for government to recognize that the economy is in a recession. Then months will pass as political parties argue over appropriate spending hikes or tax cuts. When the tax cut finally takes effect, it may take many more months before consumers and firms finally start spending again. The whole process could easily take two years. In the meantime during those two years, the economy is suffering. By the time the tax cut starts working, the recession could be over

3. **Side effects on public spending.**

   Reduced government spending to decrease inflationary pressure could adversely affect public services such as public transport and education caused by market failure.

4. **Disincentive of tax cuts**

   Increasing taxes reduces AD may cause disincentive to work , if this occurs there will be a fall in productivity and AS could fall. However higher taxes do not necessary reduce incentives to work if the income effect dominates

5. **Theoretical problems**

   Monetarists and Keynessian do not seem to agree on the efficiency of fiscal policy.

   - Monetarists claim that various type of budget deficit or surplus will have little impact or no effect upon the real national income while having adverse effects upon the rate of interest and prices.
   - Kenesian view that various type of budgets have different effects, the empirical evidence is that the net effects of taxes and expenditure are influenced by marginal propensinties to consume of those being taxed and government expenditure

6. **Inflexibility of government finance**

   Much government expenditures go to wages and salaries and it is not possible to play around with these to suit the short run needs of the government

Self-Examination Questions

Question 1

The fiscal policy has far more chances of success during a depression, but much less in an inflationary situation.

Required:

(i) Do you agree or disagree with the above statement? Explain.
(ii) Discuss the extent to which the working of taxation as a fiscal policy instrument can be used to counteract inflationary pressure.

Question 2

It is pertinent to identify the possible links between macroeconomic policies and the long- run growth rate potential Gross National Product (GNP). In the following policies below, you are required to explain the likely growth effects of each and every policy in influencing long-run growth;

(a) Fiscal Policies.
(i) Increase in tax to Gross Domestic Product (GDP) ratio
(ii) Reduction in fiscal deficit to Gross Domestic Product (GDP) ratio.
(iii) Reduction in non-capital expenditure to GNP ratio
(iv) Cuts in income, corporate, and indirect taxes with base broad widening: harmonization of indirect taxes

(b) Monetary and Interest Rate Policies.

(i) Avoidance of excessive expansion of money supply.
(ii) Achievement and maintenance of flexible and positive real interest rates, improved bank supervision, growth of money and equity markets.

(c) External policies
i. Realistic and flexible exchange-rate policy and avoidance of overvalued real exchange rates
ii. Liberalization of foreign trade and direct investment.

Other policies especially reforms in agricultural pricing and marketing, in country enterprises, and in labour market.

Question 3

Explain briefly what is crowding-out effect and what are the criticisms underlying it.

Question 4

(a) Briefly explain the extent to which taxes can be used to counteract inflationary pressures.
(b) Mention briefly any four appropriate fiscal measures that government may use to bring about stability in the economy.

Answers to Self-Assessment Questions

Answer to SEQ 1

(i) The statement is TRUE (YES)

The government dishes out more expenditure (manipulating expenditure) in projects and increase productivity while reduced tax:

ALTERNATIVE SOLUTION TO a (i)

The statement is INCORRECT (NO) if the government will focus on increase taxes so that to collect more revenues and hence will not be solving the depression problem.

(ii) Explanation on the extent to which Taxation as a fiscal policy instrument can be used to counteract inflationary pressure:

- Taxes as built in stabilizer can be used to curb prices and demand in a given level of government expenditure.
- The tax system itself tends to create a budgetary surplus to curb expenditure and demand while a created budgetary deficit would have the opposite effects during the boom and depression respectively.
- Expansionary effect during depression requires a charge in taxation which will have a decreasing effect in the tax revenue and hence result into budget deficit, thereby increase in the GDP and prices.
- Concretionary effect during a boom requires a charge that result into an increase in the tax revenues will lead to lower price and lower output.
- Therefore, taxation as a fiscal policy instrument can be used in such a way that, when economy is in recession, government should plan for a budget deficits through a mechanism that lowers tax revenue. On the other hand, revenue in a view of lowering prices during a boom.
- Both actions above are intended to offset changes in aggregate spending by consumers and private investors and lead to smooth fluctuations in the business cycle

Answer to SEQ 2

(a) Fiscal Policies

(i) **Increase in tax to GDP ratio.** This will raise the rates of domestic savings and investments in physical and human capital. However, depending on composition of taxes, possible distortions and disincentives may have an adverse impact on export performance, saving, employment and growth.

(ii) **Reduction in fiscal deficit to GDP ratio.** This will release resources towards the private sector and slow the rate of monetary expansion and, hence, the expected rate of inflation, thereby stimulating private investment and saving rates and thus increasing long-run growth.

(iii) **Reduction in non-capital expenditure to GNP ratio.** This will directly raise domestic saving rate via higher rate of government saving. There are also positive growth effects indirectly transmitted through favorable impact on private investment and saving rates of a fall in ratio of fiscal deficit to GNP.

(iv) **Cuts in income, corporate, and indirect taxes with base broad broadening: Harmonization of indirect taxes**. This will raise effective supplies of labour and capital, improve capital's marginal product, and encourage efficiency in resource allocation. These tax reforms, however, should be carefully designed to minimize revenue loss which is detrimental to domestic saving rate and long-run growth.

(b) Monetary and Interest rate Policies

(i) **Avoidance of excessive expansion of money supply.** This will increase long-run growth by reducing expected rate of inflation, thereby stimulating private saving rate and improving climate for private saving and investment. Price stability will also enhance prospects for successful financial reforms.

(ii) **Achievement and maintenance of flexible and positive real interest rates, improved bank supervision, growth of money and equity markets.** This will enhance efficient allocation of capital and may raise private saving rate. Even if later is interest-insensitive, increase in productive investments will raise long-run growth, Stabilization and strengthened bank supervision will ensure that interest rates do not rise to risky levels under the impact of interest-rate liberalization.

(c) External policies

(i) **Realistic and flexible exchange-rate policy and avoidance of overvalued real exchange rates.** This will promote long-run growth to the extent this policy leads to expansion and diversification of export wit consequent improvement in factor productivity associated with production and demand, technology transfer, development of efficient and internationally competitive management, and training of skilled workers. This favorable growth effect, however, would be partly offset by increase in the debt-service burden (in local currency), particularly for heavily indebted countries.

(ii) **Liberalization of foreign trade and direct investment.** This will improve factor productivity by removing barriers to imported inputs and to the inflow of risk capital.

(d) **Other policies** especially reforms in agricultural pricing and marketing, in country enterprises, and in labor market. This will promote greater efficiency in resource allocation; raise factor productivity and thus economic growth.

Answer to SEQ 3

Crowding-out effect and criticisms underlying it: Crowding out effect is the displacement effect caused by government policy to borrow excessively from money market or extracting money from the market by imposing excessive taxes. Crowding out effect is alternative to financing budget deficits by borrowing from the banking systems (and thereby expanding the money supply). The government can borrow money by selling gilt treasury bills or bonds securities to the public. Public may only buy securities when underlying interest rates are higher than effective or prevailing interest market rates. In order to persuade the general to buy the extra debt, the guaranteed annual interest rate offered on new securities raised. The effect of issuing higher than normal interest rates is to draw money from market and raising effective interest rates, the effect of which arises general interest rates levels. Increased interest rates in turn raises generally and crowds out or displaces private sector investment by making it more expensive to borrow or raise funds on the capital market through issue of shares or bonds.

Crowding out may be in form of:

- Financial crowding out or
- Resources crowding out.

To finance the government budget deficit, the government borrows money market.

Criticisms of crowding out effect:

- Crowding out can only occur when economy is at full employment.

Answer to SEQ 4

(a) Extent to which taxes can be used counteract inflationary pressures. Candidates are expected to construct their arguments around the following two rationales:

- Taxes as built-in-stabilizer
- Belief that taxes can be used to curb prices and demand.

The above two arguments can be further explained as follows:

- Taxes do act to some extent as built in stabilizers;
- Given the level of government expenditure, the tax system itself tends to create a budgetary surplus during a boom and a deficit during a depression;
- The created budgetary surplus would curb expenditure and demand while a budgetary deficit created would have the opposite effect and thus an anti-cyclical pressure is generated;
- This happens because revenue from direct and indirect taxes is dependent upon the level of economic activities

    - Also due to the fact that direct taxes are progressive.

(b) Appropriate fiscal measures (any 4) which may bring stability in the economy.

From economic point of view, **stability is lacking** in the economy if there are recurring cyclical phases of upward and downward cumulative movement in income, employment, prices, demand, supply and other macroeconomic variables.

Fiscal policy measures, to some extent, can be effectively used by the government to neutralize the destabilizing forces through the following theoretical framework

- Increasing public expenditure;
- Encouraging private expenditure;
- Restricting public expenditure;
- Limiting/curbing private expenditure.

The framework (scheme) may be implemented as follows:

- Incurring public investment;
- Subsidies, with or without tax concessions, can be used to encourage private consumption and investment; General reduction in tax rates or abolition of various taxes to encourage expenditure in private sector:
    - Push up profits and reduce cost of production and prices
    - Lower prices are expected to increase demand, production and employment, which eventually bring about effective demand.
- Similar action in the field of customs;
    - e.g. raising import duties diverts the domestic demand from imports to home-produced goods;
    - Reducing or abolishing export duties or giving export subsidies increases the demand for exports and contributes towards recovery from depression.
- Changes in budgetary
    - Discretionary policy measures may be taken to affect the level of aggregate demand.
- Built in responses
    - Changes in economic activities may also affect public expenditure and tax revenue.

SECTION A

PUBLIC FINANCE AND NATIONAL INCOME

A8

STUDY GUIDE A8: NATIONAL INCOME ACCOUNTING

Get Through Intro

We all have learned the concept of 'balance of nature' in our childhood, which explains how there exists a self-sufficient ecosystem that needs no support from the outside to sustain itself. Nature maintains balance between all living things as well as the environment - all living things feed off each other to help nature maintain its balance. There is a circular flow, the plants are grown in the soil, animals like the deer eat the plants, tigers eat the deer and the cycle continues. If even one of the elements of nature goes extinct, the balance will be disturbed. So, if all the tigers become extinct, then the deer will be allowed to flourish and plants will start to diminish. This will cause an imbalance in nature.

A similar principle applies to the economy. An individual earns salary, he pays money to the shopkeeper to buy grocery etc. - so this is the income for the shopkeeper, the shopkeeper spends this money to buy clothes from a retail store, the retail store deposits the money in the bank, the bank uses the money to lend, the borrower uses this money to produce goods in his factory and pay salary to his staff, the staff gets salary and pay tax to the government, the government uses the tax to provide facilities and so on. Thus, the expenditure of one sector becomes the income of another sector and the supply of goods and services by one section of the community becomes the demand of the other sections. In this Study Guide, we will discuss the meaning and concepts of national income. We will also discuss the various sectors of the economy and the flow of income in the economy.

Learning Outcomes

a) Describe the meaning of national income and national income accounting
b) Describe the concepts of national income
c) Describe measurements methods of national income
d) Describe determinants of the size of national income
e) Identify the role of the government in national income
f) Describe uses of national income statistics
g) Describe problems of computing/compiling national income
h) Explain weaknesses of using per capital income (PCI) statistics to compare standard of living among countries
i) Describe the role of the public sector in the circular flow of income and expenditure.
j) Explain the determination of equilibrium income in an economy with Two, Three and Four Sectors Models.

Describe the meaning of national income and national income accounting; describe the concepts of national income; describe measurements methods of national income; describe determinants of the size of national income.
[Learning Outcome a, b, c, and d]

1. Meaning Of National Income And National Income Accounting.

National income is the total value of all goods and services produced in the country in a given time period. National income accounting is a set of methods and principles used for measuring an economy's overall performance, focusing especially on the overall level of production of goods and services. National income accounting provides the necessary information which is used to assess the health of an economy and to forecast future growth and development of a country.

2. The Concepts Of National Income

There are different concepts of National Income, namely; GNP, GDP, NNP, Personal Income and Disposable Income etc.

(i) Gross Domestic Product (GDP)

Gross Domestic Product is the market value of the final goods and services produced within the domestic territory of a country during one year inclusive of depreciation.

(ii) Net Domestic Product at Market Price

Net Domestic Product is the market value of final goods and services produced by all the producers in the domestic territory of a country during an accounting year exclusive of consumption of fixed capital. It is equal to the net value added.

(iii) **Gross National Product (GNP)**

GNP at market price is sum total of all the goods and services produced in a country during a year and net income from abroad. GNP is the sum of Gross Domestic Product and Net Factor Income from abroad.

(iv) **Net factor income from abroad**

Difference between the factor incomes earned by our residents from abroad and factor income earned by non-residents within our country.

(v) Net National Product (NNP)

In the process of production of goods and services, there will be some depreciation of fixed capital also called as consumption of fixed capital, if the value of depreciation is deducted from the value of gross national product in a year, we obtain the value of net national product.

(vi) GNP/GDP at Market Price and at Factor Cost

GNP/GDP can either be measured at market price or at factor cost, when it is measured at market price it includes indirect taxes imposed by the government but excludes subsidies provided by the government to producers and consumers, when it is measured at factor cost it includes only factor costs i.e. factor incomes this means that in order to get GNP/GDP at factor cost, we must deduct indirect tax and add subsidies.

GNP at market price = GNP at factor cost + indirect tax – subsidies

GNP at factor cost = GNP at market price – indirect tax + subsidies

GDP at market price = GDP at factor cost + indirect tax – subsidies

GDP at factor cost = GDP at market price – indirect tax + subsidies

(vii) National income

Net National Product at factor cost is also called as national income.

(viii) Private Income

Private Income is defined as *"the total of factor income from all sources and current transfers from the government and rest of the world accruing to private sector" or in other words the private income refers to the* income from socially accepted source including retained income of corporation.

(ix) Personal Income

Prof. Peterson defines Personal Income as "*the income actually received by persons from all sources in the form of current transfer payments and factor income.*"

(x) **Disposable Income**

Prof. Peterson defined Disposable Income as *"the income remaining with individuals after deduction of all taxes levied against their income and their property by the government."* Disposable Income refers to the income actually received by the households from all sources. The individual can dispose this income according to his wish, as it is derived after deducting direct taxes.

(xi) Personal savings

It is disposable income left after paying Personal consumption expenditure

(xii) Per capita Income

Per capita Income is derived from dividing national income from the total population of the country.

(xiii) Nominal GDP and Real GDP

Nominal GDP is the market value of all final goods and services produced in a geographical region usually a country, on the other hand, Real GDP is a macroeconomic measure of the value of the output economically adjusted for price changes. Values for real GDP are adjusted for difference in price levels while figures for Nominal GDP are not adjusted. Nominal values of GDP from different time periods can differ due to change in quantities of goods and services and/or changes in general price levels while for Real GDP the difference depict solely the changes in quantities produced. Generally, Real GDP is a better index of welfare of the people, when Real GDP rises, flows of goods and services tends to rise, other things remaining constant. This means great availability of goods per person, implying higher level of welfare.

3. Determinants Of The Size Of National Income

The size of nation income will depends on the following factors

(i) The Available Stock of Natural Resource

Availability of large stock of natural resources such as minerals, water sources, soils, weather condition precipitates the growth of national income where low stock of natural resources leads to low production consequently to low national income.

(ii) Stock of Capital Goods

The size of the national income depends on the size of the capital goods available in a country; if the size of capital goods such as factories, machines, infrastructures and raw materials is large a country would experience faster growth of the national income unlike when a nation is facing a shortage of capital goods.

(iii) Level of Technology

The size of national income depends on the level of technology a country has achieved, if in a country production is done by using advanced technology output will be large as well as the national income.

(iv) Human Resources Available

National income depends on the available labour, both skilled and unskilled labour, managerial capacity, efficiency and the number of entrepreneurs.

(v) Political Situation

When there is political stability in a country investors become confident to invest their capital therefore resulting in the increase in the national income.

4. Measurement Methods Of National Income

There are three approaches for measuring GDP; the income approach, Value added approach and the expenditure approach.

(i) **Expenditure Approach**

According to the expenditure approach, the GDP is the total amount spent on goods and services by the household sector, business sector, government sector and international sector. Spending by the household sector is consumption (C), spending by the business sector is investment in capital goods (I), Government spending is (G) and exports is (X)

Thus, Total expenditure of a nation = C + I + G + (X – M)

(ii) Income Approach

According to the income approach, the GDP is the total income earned by the household sector in a year, the income of the household sector is the interest received in exchange for capital, profit received in exchange for enterprise, rent received in exchange for land and wages received in exchange for labour.

Thus,

Total income of a nation = interest + profit + rent + wages

(iii) Value-added Approach

The method measures GDP as the sum of value added at each stage of production (from initial to final stage).The main sectors whose production value is added up are: (i) agriculture (ii) manufacturing (iii) construction (iv) transport and communication (v) banking (vi) administration and defense and (vii) distribution of income.

Example 1

The 2018 National Income accounts for a Country Zinduna include the following:-

	Zin Million
Wages and Salaries	430,000
Imports of Goods and Services	220,000
Rent	50,000
Value Added in Agriculture	100,000
Govt. Current Expenditure on goods and services	130,000
Capital consumption	70,000
Value added in Construction	50,000
Consumers' Expenditure	450,000
Dividends	500,000
Income from self-employment*	60,000
Exports of goods and services	650,000
Undistributed Profit*	110,000
Gross Domestic Fixed Investment	150,000
Value added in Distributive Trades	150,000
Value added in Manufacturing	600,000
Value of Physical increase in stocks	10,000
Trading surplus of public corporations*	20,000
Value added in other sectors	270,000

*Gross of Depreciation

Required

(i) Classify these items into separate accounts of GNP, GNI, and GNE.
(ii) Calculate Net National Product, Net National Expenditure and Net National Income.

Answer

Gross National Product	**Tshs ,000 ,**	**Gross National Expenditure**	**Tshs'000'**	**Gross National Income**	**Tshs'000'**
Value added in		Consumer Expenditure.	450	Wages & salaries	430
Agriculture	100	Government exp	130	Self-employed *	60
Mining	600	Gross fixed investment	150	Company Profit	500
Construction	50	Change in stocks	10	Dividends	110
Distribution	150	Exports	650	Public corporation.	20
Other Sector	270	Import	(220)	Rent	50
GNP	**1,170**	**GNE**	**1,170**	**GNI**	**1,170**
Less: Depreciation	(70)	Less: Depreciation	(70)	Less :Depreciation	(70)
Net National Product	**1,100**	**Net National Expenditure**	**1,100**	**Net National income**	**1,100**

This is because income from self-employment profit and trading surplus of public corporation are gross of depreciation for example factor income are normally reported before making allowance for depreciation, had these figure been net of depreciation the income from these source would have been less by (60+610+20-70=620) adding these figure along with wages and salaries (430) and rent (50) we will get NNI at 1100 to this we shall add depreciation (70) to get finally GNI at 1170

Identify the role of the government in national income; describe uses of national income statistics; describe problems of computing/compiling national income; explain weaknesses of using per capital income (PCI) statistics to compare standard of living among countries.

[Learning Outcome e, f, g and h]

(i) They show the distribution of income among the various factors of production and sectors of the economy namely: the household, business and the government sectors. This is important in planning for taxes and government expenditure.

(ii) National income statistics can be used to show the growth rate of the national economy by comparing the GNP of different years, for example if the GNP of country X in the year 2000 was Tshs. 20 million and GNP of the year 2001 was Tshs. 40 then the growth rate of the national income was 100 percent. National income statistics can be used to compare the standard of living of different nations by computing the per capital incomes of each country. Per capital income is income per head, it means the average income of each citizens in a certain period of time.

$$\text{Per capital income} = \frac{\text{GNP}}{\text{Total population}}$$

(iii) They are important in estimating the level of international transactions and the degree to which an economy depends on other economies. This can be estimated from the figures of imports and exports.

(iv) Per capita income (national income divided by total population) is used in comparing the standard of living of a country over time.

(v) They show the patterns of expenditure, this is shown by figures of private and public expenditure. This is important in the making of the national budget where there is the need to estimate private and public expenditure.

(vi) They are used for international comparisons which are necessary if improvement in economic performance is to be achieved.

(vii) They measure the size of various economic sectors i.e. agriculture, industry and infrastructure or monetary and subsistence sector which is very crucial in planning and designing of development strategies.

(viii) They will also give us information on the stability of performance of the economy over time.

(ix) They show the rate of resource utilization as an increase in national income may be attributable to increased utilization of national resources.

(x) They give us figures on the savings level in a country. This helps in coming up with investment projections.

(xi) Economic problems can easily be known through the national income statistics example of these problems are such as inflation, fall in income, an employment etc.

(xii) National income can be used to show the welfare of the citizens of a country, the increase in national income implies improvement in the welfare when there is a fair distribution of the national income.

(xiii) Estimates of national income are very important in the formulation of a national budget by the government i.e. the government uses the national income statistics to estimate its revenue and expenditures for the current year likewise the government uses the national income data to formulate national plans and policies.

6. Problems Of Computing/Compiling National Income

There are many difficulties in measuring national income of a country accurately. The difficulties involved in national income accounting are both conceptual and statically in nature. Some of these difficulties involved in the measurement of national income are discussed below:

(i) Non Monetary Transactions

The first problem in National Income accounting relates to the treatment of non-monetary transactions such as the services of housewives to the members of the families. For example, if a man employees a maid servant for household work, payment to her will appear as a positive item in the national income. But, if the man were to marry to the maid servant, she would performing the same job as before but without any extra payments. In this case, the national income will decrease as her services performed remains the same as before.

(ii) Problem of Double Counting

Only final goods and services should be included in the national income accounting. But, it is very difficult to distinguish between final goods and intermediate goods and services. An intermediate goods and service used for final consumption. The difference between final goods and services and intermediate goods and services depends on the use of those goods and services so there are possibilities of double counting.

(iii) The Underground Economy

The underground economy consists of illegal and uncleared transactions where the goods and services are themselves illegal such as drugs, gambling, smuggling, and prostitution. Since, these incomes are not included in the national income, the national income seems to be less than the actual amount as they are not included in the accounting.

(iv) Petty Production

There are large numbers of petty producers and it is difficult to include their production in national income because they do not maintain any account.

(v) Public Services

Another problem is whether the public services like general administration, police, army services, should be included in national income or not. It is very difficult to evaluate such services.

(vi) Transfer Payments

Individual get pension, unemployment allowance and interest on public loans, but these payments creates difficulty in the measurement of national income. These earnings are a part of individual income and they are also a part of government expenditures.

(vii) Capital Gains or Loss

When the market prices of capital assets change the owners make capital gains or loss such gains or losses are not included in national income.

(viii) Price Changes

National income is the money value of goods and services. Money value depends on market price, which often changes. The problem of changing prices is one of the major problems of national income accounting. Due to price rises the value of national income for particular year appends to increase even when the production is decreasing.

(ix) Wages and Salaries paid in Kind

Additional payments made in kind may not be included in national income. But, the facilities given in kind are calculated as the supplements of wages and salaries on the income side

(x) Illiteracy and Ignorance

The main problem is whether to include the income generated within the country or even generated abroad in national income and which method should be used in the measurement of national income.

Besides these, the following points are also represents the difficulties in national income accounting:

- Second hand transactions;
- Environment damages;
- Calculation of depreciation;
- Inadequate and unreliable statistics; etc

7. **Roles Of The Government In National Income**

   The government policies influence the national Income of a country in many ways. Some of these are explained below.

   (i) **Education and health care policies:** increased investment in this sector contributes in improving the quality of human capital of a country which results in increased production. When production increases, the national income also increases and therefore GNP increases. It is important that a government aims to increase the quality of its workforce by increasing educational and professional training opportunities.

   (ii) **Institutional infrastructure:** improvements in the institutional infrastructure of the country in areas such as law and order, judiciary system, banking and insurance sector and stable and efficient government organisations are important to GNP growth.

   (iii) **Infrastructure policies:** improvement in the physical infrastructure of the country is fundamental to supporting economic activity and encouraging GNP growth. It includes development of roads, railway lines, airlines, bridges, dams, power generation plants etc.

   (iv) **Social policies:** strong policies to reduce unemployment, to control population, to improve social security, to make better education available, to formulate good environmental policies etc. play a vital role in the development of a country's economy and therefore have a significant impact on GNP. However, there is also a different view that needs to be understood. Although GDP and GNP reflect the overall health of the economy, an increased GDP does not always mean development. Economic wealth does not always mean good quality of life. More money within a country does not always mean better quality of life for everybody.

8. **Weaknesses Of Using Per Capital Income (PCI) Statistics To Compare Standard Of Living Among Countries**

   Per capita income =National Income/Total Population

   Per capita income is also referred to as income per head. This is calculated as shown above by taking total income divided by total population. It's the average income. It gives the amount of output per person in a given economy at a particular time. It indicates the amount of goods and services that are available for each individual in an economy. It also indicates the standards of living of people i.e. their material well being.

It assists to provide a rough estimate of the average amount of goods and services per person produced in the economy which also assists to compare productivity among regions and countries.

PCI Shortcomings:

(i) It does not show who earns what in an economy because it is just a crude figure of the general prevailing situation.
(ii) It cannot depict equitable distribution as it is just a crude figure.
(iii) It does not account for all activities e.g. trafficking, smuggling which are regarded as illegal.

Per capita income figures can also be used to compare the standards of living of different countries. Thus if the per capita income of one country is higher than that of another country, the living standard in the first country can be said to be higher. Such comparisons are made by aid giving international agencies like the United Nations and they indicate the relevant aid requirements of different countries. But there are major problems in using **real income per head** (per capita income) to measure the standard of living in different countries. First there is the whole set of **statistical problems** and, secondly, there are a number of difficult **conceptual problems** or problems of interpretation.

Describe the role of the public sector in the circular flow of income and expenditure; explain the determination of equilibrium income in an economy with Two, Three and Four Sectors Models.

[Learning outcome i, and j]

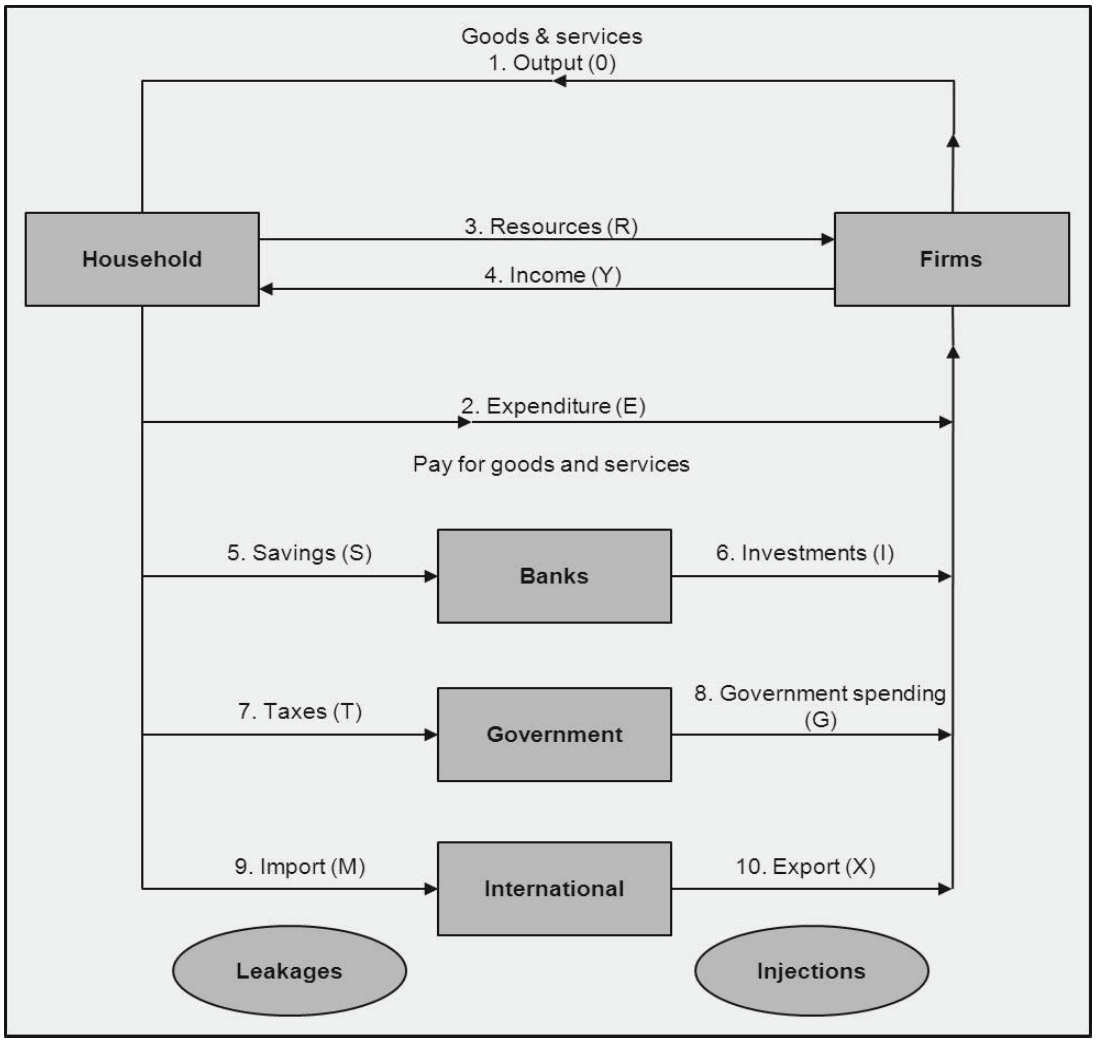
9. Role Of The Public Sector In The Circular Flow Of Income And Expenditure

A study of the economy reveals that money flows in a circular fashion in the economy; from individuals to businesses and back to individuals. The expenditure of individuals becomes the income for the businesses and the expenditure of the businesses becomes the income of the individuals.

An individual spends his income (salary, rent, dividends) for buying consumable goods and services from the businesses, for paying taxes to the government and for savings in the form of investments. The businesses use the money (spent by individuals while buying the goods and services and while making investments) to set up their business, to buy material to manufacture goods and to pay their employees.

Thus, the economy of any country can be divided into five sectors:

- Household sector: this includes all individuals and families
- Business sector: this includes the firms and organisations
- Financial sector: this includes banks and financial institutions
- Government sector: this includes the ruling bodies of the state and the central government
- International sector: this includes the import and export
- Based on the above classification, various models are framed to understand the circular flow process. The following diagram explains the five sector circular flow model
  Diagram 1: Five sector circular flow model



- We will use the above diagrammatical representation to understand how money flows through the economy through various sectors.

Two sector model

The two important sectors that exist in any economy are the household sector and the business sector. The four flows shown in the diagram are explained as follows:

1. Output (O): the most obvious flow is the provision of goods and services by the business sector to the household sector.

2. Expenditure (E): the household sector needs to pay for the goods and services supplied by the business sector.

3. Resources (R): the household sector provides the resources i.e. the factors of production to the business sector. The factors of production are capital, enterprise, land and labour (CELL).

4. Income (Y): the returns for factors of production are interest or dividend (for capital), profit (for enterprise), rent (for land) and wages (for labour)

In the two sector model, as the cash keeps flowing in the economy, the state of equilibrium is defined as a situation in which there no scope for the variations in levels of income (Y) , expenditure (E) and output (O) to change i.e. Y = E = O

Three sector model

The three sector model expands the simple two sector economy by introducing one more sector – the financial sector.

With the introduction of one new sector, two new flows arise in the economy (see diagram 1):

5. Savings (S): savings flow from households to the banks.

6. Investments (I): money goes back from banks to the business sector in the form of investments.

Thus, money for investments in the business sector is procured from savings that the household sector puts in the banks.

Four sector model

Now, let's go one step further and introduce the fourth sector - the government sector. As one new sector is introduced, two new flows arise in the economy (see diagram):

7. Taxes (T): taxes are a flow from the household sector to the government.

8. Government spending (G): government then puts the money (collected in the form of taxes) back in the flow system by way of government spending.

Five sector model

We are living in a very globalised world and we deal more and more with the international sector. Therefore the most realistic representation of the flow system is to include the international sector.

The two new sectors that arise in the economy on inclusion of the international sector are:

9. Import (M): the household sector buys goods and services from overseas

10. Export (X): the businesses sell goods and services to overseas customers

Thus, to summarise:

There are five sectors in an economy (household, business, financial, government, international).

There are four types of flows between the household sector and the business sector (output, expenditure, resources, and income).

There are three flows going out from the household sector (savings, taxes and imports). Collectively, these are called **'leakages'.**

There are three flows going into the business sector (investments, government spending and exports).

Collectively these are called **'injections'.**

In a five sector model, the state of equilibrium occurs when the total leakages are equal to the total injections that occur in the economy.

This can be shown in equation form as:

Savings + taxes + imports = Investments + government spending + exports

$$S + T + M = I + G + X$$

In other words,
If injection > leakages; this means the economy is growing
If injection < leakages; this means the economy is diminishing
If injection = leakages; this means the economy is stable

10. Explain the determination of equilibrium income in an economy with Two, Three and Four Sectors Models.

To simplify the analysis, it has been classified into a two-sector model, a three-sector model and a four-sector model.

First two sectors are related to a closed economy in which there is no foreign trade and the last sector is concerned with the open economy.

Two-Sector Model:

A two-sector model of income determination of an economy consists only of domestic and business sectors.

Assumptions:

The income determination in a closed economy is based on the following assumptions:

(i) It is a two-sector economy where only consumption and investment expenditures take place. Thus the total output of the economy is the sum of consumption and investment expenditure.
(ii) Investment relates to net investment after deducting depreciation.
(iii) It is a closed economy in which there are no exports or imports.
(iv) There are no corporate firms in the economy so that there are no corporate undistributed profits.
(v) There are no business taxes, no income taxes and no social security taxes so that disposable personal income equals NNP.
(vi) There are no transfer payments.
(vii) There is no government.
(viii) There is autonomous investment.
(ix) The economy is at less than full employment level of output.

(x) The price level remains constant up to the level of full employment.
(xi) The money wage rate is constant.
(xii) There is stable consumption function.
(xiii) The rate of interest is fixed.
(xiv) The analysis relates to the short period.

Explanation:

Given these assumptions, the equilibrium level of national income can be determined by the equality of aggregate demand and aggregate supply or by the equality of saving and investment.

Aggregate demand is the summation of consumption expenditure on newly produced consumer goods by households and on their services (C), and investment expenditure on newly produced capital goods and inventories by businessmen (I).

It is shown by the following identities:

Y = C+I ….(1)

Personal Income: Y_d = C+S….(2)

But Y= Y_d

C + I = C + S

Or I = S

Where Y = national income, Y_d = disposable income, C = consumption, S = saving, and I = investment.

In the above identities, C + I relate to consumption and investment expenditures which represent aggregate demand of an economy. C is the consumption function which indicates the relation between income and consumption expenditure.

The consumption function is shown by the slope of the C curve in Fig. 1 which is MPC (marginal propensity to consume). I is investment demand which is autonomous. When investment demands (I) is added to consumption function (C), the aggregate demand function becomes C+I.

C+S identity is related to the aggregate supply of an economy. That is why, consumer goods and services are produced from total consumption expenditure and aggregate savings are invested in the production of capital goods.

In an economy, the equilibrium level of national income is determined by the equality of aggregate demand and aggregate supply (C+I=C+S) or by the equality of saving and investment (S=I).

We explain these two approaches one by one with the help of Figure 1 (A) and (B).

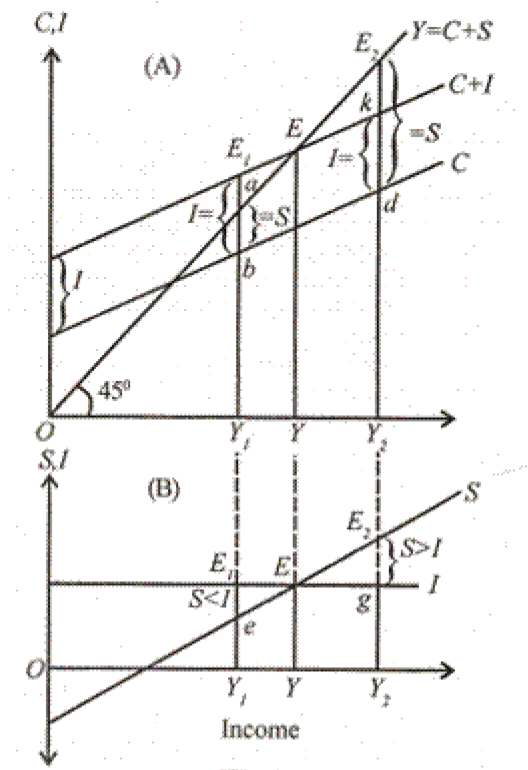


Fig. 1

Equality of Aggregate Demand and Aggregate Supply:

The equilibrium level of national income is determined at a point where the aggregate demand function (curve) intersects the aggregate supply function. The aggregate demand function is represented by C+I in the figure. It is drawn by adding to the consumption function C the investment demand I.

The 45° line represents the aggregate supply function, Y = C+S. The aggregate demand function C+I intersects the aggregate supply function Y= C+S at point E in Panel (A) of Figure 1 and the equilibrium level of income OY is determined.

Suppose there is disequilibrium in aggregate supply and aggregate demand of the economy. Disequilibrium can be in either case, aggregate supply exceeding aggregate demand or aggregate demand exceeding aggregate supply. How will the equilibrium level of income be restored in the two situations?

First, take the case when aggregate supply exceeds aggregate demand. This is shown by OY_2 level of income in Panel (A) of the figure. Here aggregate output or supply is Y_2E_2 and aggregate demand is Y_2k.

The disposable income is OY_2 (=Y_2E_2). At this income level OY_2, consumers will spend Y_2d on consumption goods and save dE_2.

But businessmen intend to make investment equal to dk in order to buy investment goods. Thus the aggregate demand for consumption goods and investment goods is Y_2d + dk = Y_2k. But aggregate supply (or output) Y_2E_2 is greater than aggregate demand Y_2k by kE_2 (=Y_2E_2 – Y_2k).

Therefore, the surplus output of goods worth kE_2 accumulated by businessmen in the form of unintended inventories. In order to avoid further inventory accumulation, they will reduce production. As a result of the reduction in output, income and employment will fall and the equilibrium level of income will be restored at OY where the aggregate supply equals aggregate demand at point E.

The second situation of disequilibrium when aggregate demand exceeds aggregate supply is shown by the income level of OY_1 in Panel (A) of the figure. Here the aggregate demand is Y_1E_1 and the aggregate output is Y_1a. The disposable income is OY_1 (=Y_1a).

At this income level, consumers spend Y_1b on consumption goods and save ba. But businessmen intend to invest bE, to buy investment goods. Thus the aggregate demand is $Y_1b + bE_1 = Y_1E_1$ which is greater than the aggregate supply of goods Y_1a by aE_1.

To meet this excess demand worth aE_1, businessmen will have to reduce inventories by this amount. In order to stop further reduction in their inventories, businessmen will increase production. As a result of the increase in production, output, income and employment will increase in the economy and the equilibrium level of income OY will be restored again at point E.

Equality of Saving and Investment:

The equilibrium level of income can also be shown by the equality of the saving and investment functions. Since the equilibrium level of income is determined when aggregate supply (C+S) equals aggregate demand (C + I) in the economy, intended (or planned) saving also equals intended (or planned) investment. This can be shown algebraically

$C + S = C + I$

$S = I$

The equilibrium level of income in terms of the equality of saving and investment is shown in Panel (B) of Figure 1, where I is the autonomous investment function and S is the saving function. The saving and investment functions intersect at point E which determines the equilibrium level of income OY.

If there is disequilibrium in the sense of inequality between saving and investment, forces will operate in the economy and the equilibrium position will be restored. Suppose the income level is OY_2 which is above the equilibrium income level OY.

At this income level OY_2, saving exceeds investment by gE_2. It means that people are consuming and spending less. Thus aggregate demand is less than aggregate supply. This will lead to the accumulation of unintended inventories with businessmen. To avoid further accumulation of inventories, businessmen will reduce production. Consequently, output, income and employment will be reduced till the equilibrium level of income OY is reached at point E where S=I.

On the contrary, if the income level is less than the equilibrium level, investment exceeds saving. This is shown by OY_1 level of income when investment Y_1E_1 is greater than saving. The excess of intended investment over intended saving means that aggregate demand is greater than aggregate supply by eE_1.

Since aggregate output (or supply) is less than aggregate demand, businessmen will decrease inventories held by them. To stop further reduction in their inventories, they will increase production. Consequently, output, income and employment will increase in the economy and the equilibrium level of income OK will be again reached at point E.

The determination of equilibrium level of income simultaneously by the equality of aggregate demand and aggregate supply and of saving and investment is explained in Table I below.

Table

Table 1

Panel (A)			Panel (B)
$Y=C+I$	at the equilibrium point	E	and $S=I$
$Y>C+I$	to the right of	E	and $S>I$
$Y<C+I$	to the left of	E	and $S<I$

Determination of National Income in Three-Sector Economy

Determination of equilibrium level of income in an economy that has only two sectors, namely, the households' and the producers' sectors. Such economies do not survive in real world for long.

They need a regulatory authority for their smooth functioning sooner or later. Invariably, a government sector becomes inevitable, more so, when the state is a welfare state. Apart from acting as a producer, the government of a welfare state acts as a watchdog to all the activities of production and consumption. Taxation – direct and indirect – provides a source of income for the government and public expenditure and transfer payments, as channels of its spending.

(A) When Taxation is Autonomous:

The aggregate demand (AD) for an economy with three sectors, namely, the households' sector, the producers' sector and the government sector, can be expressed as

AD = C + I + G

Here, G = government spending on goods and services.

$I = I_a$, the autonomous investment.

(In this section, we will proceed with the assumption that investment is fixed) The Aggregate Supply (AS), in like manner, can be expressed as

AS = C + S + T

Here, T = tax revenue net of transfer payments. Taxation assumed fixed at T_a and the transfer payments assumed fixed at R, the tax revenue net of transfer payments, $T = T_a - R$.

AS = Y, as in 6.1, would again lead to a 45° line while $AD = C + I_a + G$ would be a vertical displacement of $C = C_a + bY^d$, first by I_a and then by G. Here, Y^d is the disposable income given as

Y^d = National Income – Tax Revenue net of Transfer payments.

$= Y-[T_a-R]$

$= Y-T_a+R$

Equilibrium level of income would refer to the condition AD = AS. The reader can easily verify that the equilibrium condition would stand modified to

$I_a + G = S + T$

where, $I_a + G$ = injections

and, $S + T$ = withdrawals.

Algebraically, combining AS = Y and AD = C + I_a + G, we have

$Y = C + I_a + G$

$= C_a + bY^d + I_a + G$

$= C_a + b[Y – (T_a – R)] + I_a + G$

$= C_a + bY – bT_a + bR + I_a + G$

$(1 – b)Y = C_a – bT_a + bR + I_a + G$

$Y = 1 / (1 – b) [C_a – bT_a + bR + I_a + G]$

This, as evident, has been obtained from the equality of AD and AS. The same result can be obtained through the equality of injections and withdrawals as in the lower panel.

$I_a + G = S + T$

$= – C_a + (1 – b) Y^d + T$

$= -C_a + (1 – b) [Y – T_a + R] + T_a – R$

$(Y^d = Y – T = Y – T_a + R$ and $T = T_a – R)$

$= – C_a + (1 – b) Y – (1 – b)T_a + (1 – b)R] + T_a – R$

$= – C_a + (1 – b) Y – T_a + bT_a + R – bR + T_a – R$

$(1 – b)Y = C_a – bT_a + bR + I_a + G$

$Y = 1 / (1 – b) [C_a – bT_a + bR + I_a + G]$

We can now define three more multipliers, namely, the government expenditure multiplier (dY/dG), the taxation multiplier (dY/dT_a) and the transfer payments multiplier (dY/dR) as follows:

$K_G = dY / dG = 1 / (1 – b)$

$K_{Ta} = dY / dT_a = -b / (1 – b)$

$K_R = dY / dR = b / (1 – b)$

An illustration would be in order here to explain the concepts.

Illustration

For a hypothetical economy with three sectors, the following specifications are provided:

$C = 20 + 0.75Y^d$

$I_a = 20$

$G = 25$

$T_a = 25$

Determine:

(i) The equilibrium level of income through the equality of the AS and AD as well as through that of the injections and withdrawals.

(ii) Investment multiplier, Govt expenditure multiplier and tax multiplier.

(iii) Disposable income, consumption expenditure and the level of savings at equilibrium.

(iv) Effect on the national income of each of the following changes:

1. Investment increases to 30.
2. Govt expenditure increases to 40.
3. Tax decreases to 20.

(v) $(dY/dT_a) + (dY/dG)$. Can you interpret the result?

Solution:

(i) AD = AS. We have

$Y = 1 / (1 – b) [C_a – bT_a + bR + I_a + G]$

Substituting data from the question, $b = 0.75$, $C_a = 20$, $G = T_a = 25$, $I_a = 20$, $R = 0$; we have

$Y = 1 / (1 – 0.75) [20 – 0.75 \times 25 + 0.75 \times 0.00 + 20 + 25]$

$Y = 4.00 [20 – 18.75 + 0.00 + 45] = 185.$

Equality of injections ($I_a + G$) to withdrawals ($S + T$) can be verified to yield the same result.

The investment multiplier, K_{Ia} (using subscript I_a to distinguish it from other multipliers and to have identical notation for it), we have

$K_{Ia} = 1 / (1 – b)$

$= 1 / (1 – 0.75) = 4.00$

Government expenditure multiplier, K_G can be calculated as

$K_G = 1 / (1 – b)$

$= 4.00$ (as above)

Tax multiplier, K_{Ta} from equation 6.23, is

$K_{Ta} = -b / (1 – b)$

$= – 0.75 / (1 – 0.75)$

$= – 3.00$

Likewise transfer payments multiplier,

$K_R = b / (1 – b)$

$= 0.75 / (1 – 0.75) = 3.00$

(iii) Disposable income, Y^d, at the equilibrium,

$Y^d = Y – T_a + R$

$= 185 – 25 + 0.00 = 160$

Consumption expenditure at the equilibrium level of income,

$C = C_a + bY^d$

$= 20 + 0.75 \times 160$

$= 20 + 120 = 140$

Savings at the equilibrium,

$S = – C_a + (1 – b) Y^d$

$= – 20 + (1 – 0.75) \times 160 = 20$

Even directly, savings,

$S = Y^d – C = 160 – 140 = 20$

(iv) $\Delta I = 30 – 20 = 10$, $K_{Ia} = 4.00$

$\Delta Y = (K_{Ia}) \Delta I_a = 4.00 \times 10 = 40.$

Thus when investment increases from 20 to 30, increase in income would be 40.

$\Delta G = 40 – 25 = 15$, $K_G = 4.00$

$\Delta Y = (K_G) \Delta G$

$= 4.00 \times 15 = 60.00$

That is, an increase in government spending by 15 increases national income by 60.

$\Delta T_a = 20 – 25 = – 5.00$, $K_{Ta} = – 3.00$

$\Delta Y = (K_{Ta}) \times \Delta T_a$

$= (- 3.00) \times (- 5.00) = 15.00$

That is a decrease in tax from 25 to 20, increases income by 15.00.

(v) Note that the sum of the government expenditure multiplier and the tax multiplier,

$K_G + G_{Ta} = 4.00 + (-3.00) = 1.00$

Even directly, $[1 / (1 – b)] + [-b / (1 – b)] = (1 – b) / (l – b) = 1.00$

The result that the sum of the government expenditure multiplier and the tax multiplier is unitary, is at times referred to as the unit budget multiplier theorem or even as the balanced budget multiplier theorem. The significance of this theorem is that the national income increases only by the amount of the increase in tax financed government spending under a balanced budget. To explain, let

$\Delta T = 10$

$\Delta G = 10$

Then, increase in income due an increase in taxes by 10 is

$\Delta Y = (K_{Ta}) \times \Delta T$

$= (-3.00) \times (10)$

$= -30.00$

Increase in income due to an increase in government expenditure by 10 is given as

$\Delta Y = (K_G)\ \Delta G$

$= 4.00 \times 10 = 40.$

Total increase in income due to an increase in taxes by 10 under the balanced budget, thus, is given as (-30) + (40) = 10. That explains the significance of the theorem.

(B) When Taxation Is Progressive/Digressive:

In our analysis of equilibrium of a three-sector economy, we assumed that taxation is purely autonomous in character. The assumption was intended to simplify the model at its introduction stage. Now that the purpose is served, we relax the assumption and take taxation in its most common form, the one in which it is a function of income..

The equation describes it as a function of income comprising of two components, one, purely autonomous (T_a) and the other, purely progressive (tY) in character. A tax is termed as progressive when its rate increases with increasing income.

The incomes for the purpose are divided into several income-slabs with the lowest slab subjected to the lowest rate of taxation and the highest, to the highest rate. When incomes, high or low, are subjected to the same rate, taxation is termed as proportional and when incomes up to a certain slab are subjected to progressive taxation and thereafter to proportional taxation, the system of taxation is termed as a digressive one. Income tax in India, for example, is a digressive tax. Returning to the tax function,

$T = T_a + tY$

Where, T_a is autonomous component and 't', the rate of tax and 'Y', the income. Aggregate demand (AD) under purely progressive component, tY transforms as

$AD = C + I_a + G$

$= C_a + bY^d + I_a + G$

$= C_a + b[Y – (T – R)] + I_a + G$

$= C_a + b [Y – T + R] + I_a + G$

$= C_a + b [Y – tY + R] + I_a + G$

$= C + bY – btY + bR + I_a + G$

Aggregate supply (AS) remaining unchanged, is given as

$AS = Y$

For equilibrium, AD = AS = Y.

Hence,

$Y = C_a + bY – btY + bR + I_a + G$

$(1 – b + b t)Y = C_a + b R + I_a + G$

$Y = 1 / (1 – b + bt) [C_a + bR + I_a + G]$

Equation 6.26 gives the equilibrium level of income, with the following multipliers

$dY / dG = 1 / (1 – b + bt)$

$dY / dI_a = 1 / (1 – b + bt)$

$dY / dR = b / (1 – b + bt)$

Apart from the above, with which the reader is already familiar, we have yet another multiplier, the tax rate multiplier, given as

$dY / dt = [-b / (1 – b + bt)^2] [C_a + bR + I_a + G]$

$= [-b / (1 – b + bt)] \times [1 / (1 – b + bt)] [C_a + bR + I_a +G]$

$= -bY / (1 – b + bt)$

$Y = \{1 / (1 – b + bt)\} \{C_a + bR + I_a +G\}$, and $t = (t + dt)\}$

Aggregate demand (AD) under the tax function), transforms to

$AD = C + I_a + G$

$= C_a + bY^d + I_a + G$

$= C_a + b\,[Y – (T_a + tY – R)] + I_a + G$

$= C_a + b\,[Y – T_a – tY + R] + I_a + G$

$=C_a + bY – bT_a – btY + bR + I_a + G$

Aggregate supply (AS) remaining unchanged,

$AS = Y$

For equilibrium, AD = AS. Hence,

$Y = C_a + bY – bT_a – btY + bR + I_a + G$

$= (1 – b +bt)Y = C_a – bT_a + bR + I_a + G$

$Y = 1 / (1 – b + bt)\,[C_a – bT_a + bR + I_a + G]$

This gives the equilibrium level of income, with the following multipliers

$dY / dG = 1 / (1 – b + bt)$

$dY / dI_a = 1 / (1 – b + bt)$

$dY / dR = b / (1 – b + bt)$

$dY / dT_a = -b / (1 – b + bt)$

Hence, we have

$dY / dT_a + dY / dG = (1 – b) / (1 – b + bt) < 1$

In part (A) of this section, we showed that the sum of the government expenditure multiplier (dY/ dG) and the tax multiplier (dY / dT_a) is 1 under autonomous taxation,

$dY / dT_a + dY / dG = 1$

We also identified this result as unit multiplier theorem.

Under digressive taxation, the unit multiplier theorem collapses.

Let us have an illustration to demonstrate the three-sector model with digressive taxation.

Illustration

For a hypothetical economy with following specifications,

$C = 2000 + 0.80\ Y^d$

$I_a = 500$

$G = 400$

$R = 100$

$T = 100 + 0.25\ Y$

Determine:

1. Equilibrium level of Income, tax revenue, disposable income, consumption and savings

2. Relevant multipliers

3. Effect on income of each of the following

(a) Increase in government spending by 20

(b) Increase in autonomous taxation by 20

(c) Decrease in autonomous investment by 50

(d) Decrease in transfer payments by 50.

(e) Increase in tax rate by 5%

4. Budget Surplus at equilibrium

SOLUTION

1. From Equation 6.31, we have, on substitution of data,

$$Y = \frac{1}{(1 - 0.8 + 0.8 \times 0.25)} [2000 - 0.8 \times 100 + 0.8 \times 100 + 500 + 400]$$
$$= 2.5 \times 2900$$
$$= \mathbf{7250}$$

Substituting this in tax function, we have

$$T = 100 + 0.25 \times 7250$$
$$= \mathbf{1912.50}$$

Substituting this in the expression of disposable income, we have

$$Y^d = Y - T + R$$
$$= 7250 - 1912.50 + 100$$
$$= \mathbf{5437.50.}$$

Substituting for Y^d in expressions for consumption and savings, we have

$$C = 2000 + 0.80\ Y^d$$
$$= 2000 + 0.8 \times 5437.50$$
$$= \mathbf{6350.00}$$
$$S = -C_a + (1 - b)\ Y^d$$
$$= -2000 + (1 - 0.8) \times 5437.50$$
$$= -\mathbf{912.50} \text{ (Dissavings)}$$

Note that withdrawals $= S + (T - R) = -912.50 + (1912.50 - 100) = \mathbf{900}.$

Injections $= I_a + G = 500 + 400 = \mathbf{900}$

2. $$\frac{dY}{dG} = \frac{dY}{dI_a}$$
$$= \frac{1}{(a - b + bt)}$$

Four Sector Model: Income Determination in Open Economy:

We shall now show how national income is determined in an open economy. For this, we relax the assumptions that there are no exports or imports and government expenditures. This means that we shall have to add imports and exports and government expenditures and taxation in our analysis.

It may be noted that government expenditures are like investment because they raise the demand for goods. They are injections in the national income. On the other hand, taxes are leakages in the national income like savings because they tend to reduce the demand for consumer goods.

The impact of exports and imports is similar to that of the government expenditure. Exports are injections because they increase the demand for goods in the same economy. Imports, on the other hand, are leakages in the national income because they represent the supply of goods to the given economy.

Assumptions:

The analysis of the determination of income in an open economy is based on the following assumptions:

1. The domestic economy's international trade is small relative to total world trade.

2. There is less than full employment in the economy.

3. The general price level is constant up to the full employment level.

4. Exchange rates are fixed.

5. There are no tariffs, trade and exchange restrictions.

6. Gross exports are determined by external factors.

7. Exports (A), investment (I) and government expenditure (G) are autonomous.

8. Consumption (C), imports (M), savings (S) and taxes (I) are each a fixed proportion of national income (Y) and their relationships with national income are linear.

Determination of Equilibrium Level of Income:

Given these assumptions, an open economy is in equilibrium when its national expenditure (E) is equal to its national income (Y).

This can be shown in the following equation for the equilibrium level of income:

Y= E=C+I+G+(X-M)

But Y = C+S+T

C+S+T= C+I+G+(X-M)

In the above analysis, C+S+T is gross national income (GNI) and C+I+G+(X-M) is gross national expenditure (GNE). Thus the equilibrium level of income in an economy is determined when aggregate supply, GNI=GNE, aggregate demand, or, C+S+T=C+I+G+(X-M).

Self-Examination Questions

Question 1

You are given the following data of a country:

		Tshs 'Billions'
1	National income	5,050
2	Income from property and entrepreneurship to gov. administrative department	500
3	Saving of non-department public enterprises	100
4	Corporation tax	80
5	Current transfer from govt: administrative depart	200
6	Net factor income from abroad	(50)
7	Direct personal tax	150
8	Indirect taxes	220
9	Current transfer from Raw	80
10	Saving of private corporate sector	500

Required:

Calculate

(i) Private income

(ii) Personal disposable income

Question 2

You are given the following data of a country:

		Tshs' Billions'
1	Factor income from NDP accruing to private sector	300
2	Income from entrepreneurship and property accruing to government administrative department	70
3	Savings of non-departmental enterprises	60
4	Factor income from abroad	20
5	Consumption of fixed capital	35

6	Current transfer from rest of the world	15
7	Corporation taxes	25
8	Factor income to abroad	30
9	Current transfer from govt governmental admi depart	40
10	Direct taxes paid by house hold	20
11	National dept interest	5
12	Saving of private corporate sector	80

Required:
Calculate
(a) Private income
(b) Personal income
(c) Personal disposable income.

Question 3
You are given the following data of a country:

		Tshs'Billions'
1	Net indirect tax	5
2	Net domestic fixed capital formation	100
3	Net exports	(20)
4	Gov.: final consumption expenditure	200
5	Net current transfer from abroad	15
6	Private final consumption expenditure	600
7	Change in stock	10
8	Net factor from abroad	5
9	Gross domestic fixed capital formation	125

Required
Calculate national income and gross national disposable income.

Question 4
You are given the following data of a country:

		Tshs'Billions'
1	Net indirect taxes	90
2	Compensation of employers	400
3	Personal taxes	100
4	Operating surplus	200
5	Corporation profit tax	80
6	Mixed income of self-employed	500

7	National debt interest	70
8	Saving of non-departmental enterprises	40
9	Current transfer from govt	60
10	Income from property and entrepreneurship to govt administrative department	30
11	Net current transfer from RAW	20
12	Net factor income from abroad	(50)
13	Saving of private corporate sector	20

Required:

Calculate

(a) Net national Disposable Income

(b) Personal Income**.**

Question 5

(a) Measures of national income and output are used in public finance to estimate the value of goods and services produced in the country. They use a system of national accounts or national accounting. Some of the more common measures are Gross National Product (GNP), Gross Domestic Product (GDP), Gross National Income (GNI), Net National Product (NNP) and Net National Income (NNI).

Required:

(i) Briefly explain THREE approaches on how the above measures can be obtained.

(ii) Why these approaches give the same results?

(iii) Under what circumstances they may produce the different results.

(b) Gross National Product (GNP) per person is often regarding as a measure of a person's welfare. Countries with higher GNP may score highly on other measures of welfare, such as life expectancy. However, there are serious limitations to the usefulness of GNP as a measure of welfare.

REQUIRED

Briefly explain five of such limitations.

Question 6

Various Expenditures and Incomes in Bahiti country are provided below

	Amount (millions)
Household consumption spending	750
Business purchases of capital	120
Government spending	250
Purchases of new homes	30
Additions to inventory stocks	60

Government transfer payments	40
Personal income tax payments	55
Indirect business taxes	35
Depreciation of capital stock	25
Imports of goods and services	25
Exports of goods and services	10
Factor payments from abroad	60
Factor payments to foreigners	45
Corporate income tax payments	75
Wages and salaries	750
Rent	120
Interest income	115
Subsidies	165
Profits	315

Question 7

Using the following national income accounting data, compute (a) GDP, (b) NDP, (c) NI.

Compensation of employees	194,200,000
Exports of goods and services	17,800,000
Consumption of fixed capital	11,800,000
Government purchases of goods and services	59,400,000
Indirect business taxes	14,400,000
Net private domestic investment	52,100,000
Transfer payments	13,900,000
Imports of goods and services	16,500,000
Personal taxes	40,500,000
Net foreign factor income earned	2,200,000
Personal consumption expenditures	219,100,000

Question 8

(a) Calculate the national income and personal disposable income from the following information

	Billions
GDPMmp	6,000
Receipts of factor income from the rest of the world	150
Receipts of factor income to the rest of the world	225
Depreciation	800
Indirect taxes minus subsidies	700
Corporate profits	1,200
Dividends	600
Transfer payments to persons	1,300
Personal taxes	1,500

(b) Calculate Net Domestic Product at Market Prices and National Income, from the following data

	Billion
Subsidies	10
Sales	1,000
Closing stock	100
Indirect taxes	50
Intermediate consumption	300
Opening stock	200
Consumption of fixed assets	150
Net factor income from abroad	10

Question 9

(a) Discuss **four** factors which should be considered when comparing national income statistics from different countries.

(b) Explain the concepts of leakages and injection from the circular flow of income.

Question 10

Explain how Tanzania's Gross Domestic Product (GDP) could be affected by **any two** of the following.

(i) An increase in Child Benefit payments.

(ii) A foreign-owned company, operating in Tanzania, sends back to their home country all the profits they have earned in Tanzania.

(iii) An oil spill off the Tanzania coast costs the Tanzania Government significant clean-up costs.

Question 11

(a) Describe the problem of 'double counting' when compiling National Income statistics

(b)

(a) Given that Gross National Product at Current Market Prices is Tshs 200b, price subsidies Tshs 5b, depreciation Tshs 12b and indirect taxes Tshs 30b.

(b) Calculate the value of **each** of the following: **Show all your workings.**

(i) Gross National Product at Factor Cost;

(ii) Net National Product at Factor Cost/National Income.

(c) State and explain **four** reasons why care should be taken when using National Income Statistics as a measure of economic performance of a country.

Question 12

Economists use Gross Domestic Product (GDP) and Gross National Product (GNP) as measures of economic activity.

a) Define **each** of the underlined terms.

b) Which of these terms do you consider to be a more useful measure of economic activity for Tanzania? Explain your answer.

c) Discuss **three** limitations of national income statistics.

Question 13

The following is the hypothetical data that relates to the Tanzania economy for the year ended 30th June, 2018 (*All figures are in billion TZS*):

Income receipts from rest of the world	329.1
Statistical discrepancy	25.6
Government consumption of fixed capital	218.1
Income payments from rest of the world	273.9
Gross National Product	11059.3
Private consumption of fixed capital	1135.9

Required:

From the above information, determine Tanzania's national income for the year 2018.

Question 14

Below, is the information extracted from the accounts of a certain manufacturing enterprise. These data can be related in some way with the national accounts data in order to determine the contribution of the enterprise to the Gross Domestic Product (GDP):

	Tshs.
Opening stock of intermediate inputs	5,000,000
Purchases	100,000,000
Sales	200,000,000
Manufacturing cost of complete work transferred to finished goods stock	145,000,000
Closing stock (intermediate goods)	15,000,000
Factory wages	50,000,000
Opening stock (inventories of goods produced)	22,500,000
Closing stock (inventories of goods produced)	17,500,000
Cost of sales	145,000,000
Gross profit	55,000,000
Salaries	15,000,000
Sales wages	10,000,000
Interest	5,000,000
Depreciation	7,500,000
Rent	2,500,000
Net profit	15,000,000

Required:

Determine the contribution of this enterprise to the GDP using:

(i) Income method

(ii) Product method

Question 15

(a) National income accounting is a set of methods and principles used for measuring an economy's overall performance, focusing especially on the overall level of production of goods and services.
Required:
Discuss why it is important to analyse the National Income Accounts of a Country.

(b) (i) Discuss the extent to which government policies influence Gross Domestic Product (GDP) and National Income (NI) of a country. Give examples in the context of Tanzania.
(ii) Show the limitation of Gross Domestic Product (GDP) application.

Question 16

In a single day Mr. Jiriani, the barber, collects TZS.50,000 from haircuts, over this day, his equipment depreciates in value by TZS.5,000 of the remaining TZS.45,000 Mr. Jiriani pays value added tax worth TZS.3,000 takes home TZS.20,000 and retains TZS.22,000 for improvement and buying of new equipment. He further pays TZS.20,000 as income tax from his income.

Required:

Based on this information, compute Mr. Jiriani's contribution to the following measures of income:

(i) Gross Domestic Product.
(ii) NNP at Market Price.
(iii) NNP at Factor Cost.

Question 17

The table below shows the national income of a country in 2018. Use the data to answer the questions that follow:

	Currency units in billions'
Personal consumption	3,657
Depreciation	400
Wages	3,254
Indirect business taxes	500
Interest	530
Domestic investment	741
Government expenditures	1,098
Rental income	17
Corporate profit	341
Subsidies	15

Exports	673
Net foreign factor income	20
Proprietor's income	403
Imports	704

Required:
Calculate the:
(i) Gross Domestic Product (GDP) using expenditure approach
(ii) Gross Domestic Product (GDP) using income approach
(iii) Net Domestic Product (NDP)
(iv) Determine the National Income at factor cost from the Net National Product (NNP)

Question 18
For each of the three approaches of estimating national income, state one limitation which may affect the estimates.

Question 19
All individuals and entities within an economy are influenced by the economic production and growth in a country, which is the Gross Domestic Product (GDP) of that country. In a bad economy, businesses would make lower profits, leading to a bad influence on the stock market. On the other hand, in a good economy, there is a high level of employment and higher income which results to higher Gross National Product (GNP).
Therefore, appropriate measures need to be taken in the country to improve the GNP, which in turn will result in improving the economy of a country. As the economic policies for a country are decided by the government, it plays a very important role in the growth of a country's economy".
Required:
Discuss how government policies influence the GNP and the National Income of a country.

Answers to Self-Examination Questions

Answer to SEQ 1
(i) Private Income = 1 – 2- 3 + 5 + 9
5050 – 500 – 100 + 200 + 80
5430 – 500
Private Income = Tshs 4,930 billions
(ii) PDI = Private Income – 4 -10 -7
4930 -80 -500 -150
PDI = Tshs 4,200 billions

Answer to SEQ 2
(i) Private Income = 1 + 5 + 7 -9 + 10 + 12
= 300 + 20 + 15 -30 + 40 + 05
Private Income = Tshs 350 billions

(ii) Personal Income = Private income – 8 – 13
= 350 – 25 – 80
Personal Income = Tshs 245 billions

(iii) PDI = Personal Income – 11
= 245 – 20
PDI =Tshs 225 billions

Answer to SEQ 3

(i) National Income (NNP FC)
= (4) + (6) + (2) + (7) + (3) = NDP MP
= 200 + 600 + 100 + 10 + (-20)
= 910 -20 = 890
NDP MP = Tshs 890 billions
NNP FC = NDP MP + (8) – (1) = 890 + 5 -5
NNP FC = 890
Depreciation = (9) – (2)
125 – 100 = Tshs 25 billions

(ii) GNDI = NNP FC + Net Indirect Tax + Net Current transfers from abroad + depreciation
= 890 = 05+ 15 + 25
GNDI = Tshs 935 billions

Answer to SEQ 4

Net national Disposable Income

NDPfc = (2) + (4) + (6)
400 + 200 + 500 = Tshs 1100 billions
NNDI = NDP fc + (12) + (1) + (11)
=1100 + (-50) + 90 + 20
NNDI = 1210 – 50
= Tshs 1160 billions

Personal Income

Private Income = NDP FC –(8) – (10)
1160 -40 – 30= Tshs 1,090 billions
1090 + 7 + 9 +11 +12
1090 + 70 + 60 + 20 + (-50) = 1,190 billions
Personal income = Private Income – Corporation Profit Tax – Savings of private corporate Sectors
1190 – 80 – 20= Tshs 1,090 billions

Answer to SEQ 5

(a)

(i) There are various ways of calculating national income and out fact:

- The **expenditure approach** determines aggregate demand, or Gross National Expenditure, by summing consumption, investment, government expenditure and net exports.
- The **income approach** and the closely related **output approach** summing wages, rents, interest, profits, non-income charges, and net foreign factor income earned.
- **Product approach**.

(ii) The three methods must yield the same result because total expenditures on goods and services (GNE) must by definition equal the value of goods and services produced (GNP) which must equal total income paid to the factors that produced the goods and services (GNI).

(iii) They may produce different result under two circumstances:

- **Changes in inventory levels**
  Minor differences are obtained from the various methods due to changes in inventory levels. This is because goods in inventory have been produced (and therefore included in GDP), but not yet sold (and therefore not yet included in GNE).

- **Timing**
  Similar timing issues can also cause a slight discrepancy between the value of goods produced (GDP) and the payments to the factors that produced the goods, particularly if inputs are purchased on credit.

(b) **Limitations of GNP as measure of welfare**

(i) Measures of GNP typically exclude unpaid economic activity, most importantly domestic work such as childcare. This leads to distortions; for example, a paid childminder's income contributes to GNP, but an unpaid parent's time spent caring for children will not, even though they are both carrying out the same economic activity.

(ii) GNP takes no account of the inputs used to produce the output. For example, if everyone worked for twice the number of hours, then GNP might roughly double, but this does not necessarily mean that workers are better off as they would have less leisure time. Similarly, the impact of economic activity on the environment is not measured in calculating GNP.

(iii) Comparison of GNP from one country to another may be distorted by movements in exchange rates. Measuring national income at purchasing power parity may overcome this problem at the risk of overvaluing basic goods and services, for example subsistence farming.

(iv) GNP does not measure factors that affect quality of life, such as the quality of the environment (as distinct from the input value) and security from crime. This leads to distortions – for example, spending on cleaning up an oil spill is included in GNP, but the negative impact of the spill on well-being (e.g. loss of clean beaches) is not measured.

(v) GNP is the mean wealth rather than median wealth. Countries with a skewed income distribution may have a relatively high per-capital GNP while the majority of its citizens have a relatively low level of income, due to concentration of wealth in the hands of a small fraction of the population.

Answer to SEQ 6

1. *GDP from the expenditure approach* GDP = Consumption + Govt. Expenditure + Investments + (Exports - Imports)
   GDP = 750 + 250 + 120 + 30 + 60 + (10 - 25) = 1,195
2. *GDP from the income approach*
   GDP = Wages + Interest + Rent + Profits + Depreciation + Indirect taxes – Subsidies
   GDP = 750 + 115 + 120 + 315 + 25 + 35 - 165 = 1,195
3. GNP = GDP + (Net Payment from Abroad)
   = GDP + Payments Received from Abroad – Payments to Foreigners

= 1,195 - 45 + 60 = 1,210

4. *Net National Product (NNP)*
   = NNP = GNP – Depreciation
   = 1,210 - 25 = 1,185
5. *National Income (NI)*
   NI = Wages + Profits + Interests + Rents + Net Payment from Abroad
   = 750 + 315 + 115 + 120 - 45 + 60 = 1,315

Answer to SEQ 7

4.	Personal consumption expenditures (C)	219.1m
	Government purchases (G)	59.4m
	Gross private domestic investment (Ig)	63.9m
	(52.1 + 11.8)	
	Net exports (Xn) (17.8 - 16.5)	1.3m
	Gross domestic product (GDP)	343.7m
5.	Consumption of fixed capital	-11.8m
	Net domestic product (NDP)	331.9m
6.	Net foreign factor income earned in	-2.2m
	Indirect business taxes	-14.4m
	National income (NI)	315.3m

Answer to SEQ 8

(i)

(i) National income is Net National product at factor cost

N1 or NNP =GDPmp –Depreciation-Net Indirect Taxes +Net Factor income from abroad

=6,000-800-700+ (150-225)
=6,000-1,500-75
=6,000-1,575
= 4,425

(ii) Personal disposable income=National income-Retained corporate profits +Transfers payments to persons-personal Taxes
=4425-(1200-600)+1300-1500
=4425-600+1300-1500
=3625

(ii) NDPmp and National income be obtained through value added method.Net domestic product at market price is the sum of net value added by all enterprises in the economy.

Value of output =Sales +change in stock

=1000+ (closing stock-opening stock)

=1000+ (closing stock-opening stock)

=1000 +(1000-200) = 900

Net value added (NVA) at market prices (NDPmp)=Value of output-intermidiate consumption-consumption of fixed fixed capital

=900-300-150

=450

National income (NNPfc) =NDPfc- Net Indirect Taxes +Net Factor income from abroad

=450-(50-10) +10

=450-40+10

=420

Answer to SEQ 9

(i) **Population/ Should be done on a per capita basis** The population in different countries must be considered with changes in national income when assessing a country's economic performance. If national income grows at a slower rate than population, then income per head decreases and the average standard of living will fall. Per capita income is a more meaningful measure of living standards than national income.

(ii) **The price levels / levels of inflation** An increase in prices will increase national income but standard of living may fall. So changes in national income must be compared with changes in prices to consider the impact on standard of living / economic performance. GDP at constant prices is a better indicator of economic growth than GDP at market prices.

(iii) **Common currency/ Must express each countries National Income in a common currency** This conversion is usually by means of foreign exchange rates which are based on the prices of internationally traded goods and services/ Usually done in US dollar. Non-internationally traded goods and services form a greater part of the national product of LDCs. So these national income statistics would be understated.

(iv) **Distribution of national income and poverty within each country** National Income statistics give headline figures as to the overall economic performance. Further research needs to be undertaken to find how income is distributed. E.g., two countries might have the same level of GNP. However, the income distribution might be very different in both countries with consequences for the welfare of the citizens.

(v) **Size of the black economy** The black economy is excluded from the calculation of national income. The value of unreported transactions is difficult to ascertain, thus underestimating the level of national income.

(vi) **Nature of government expenditure / statistics ignore economic wellbeing** A country which spends a small amount on military equipment and a larger amount on health, education etc. will have a better standard of living than one where the reverse is the case i.e. much of its wealth is on armaments. There is a large difference in terms of relative economic well-being between the two countries yet the National Income data doesn't reflect this difference.

(vii) **Government services at cost price** / **Non- marketable goods and services** Government services are included at cost while private services are included at selling price. A country where the government provides many services will record a lower GDP / national income.

(viii) **Issues specific to individual countries which affect the standard of living in different countries:** Climate /pollution/working conditions etc.

(b) Leakages are the withdrawals from the circular flow of income. The household sector does not put all their income in business sector, some income is put aside in the form of saving, some is paid to government in the form of taxes and some is used to buy goods from other countries. Thus, the savings (S), taxes (T) and imports (M), collectively are called as leakages from the circular flow of income. Injections into the circular flow are additions to the circular flow from other sectors. This includes investment from business sector, government spending and income from exports to other countries An economy is in equilibrium when: injections = leakages

Answer to SEQ 10

(i) An increase in Child Benefit payments.

This has **no** impact on GDP Child benefit is a transfer payment i.e. it is a payment for which no good or service is given in return. It is therefore **not** included in GDP. It is financed through taxation and has no impact on GDP.

(ii) A foreign-owned company, operating in Tanzania, sends back to their home country all the profits they have earned in Tanzania.

There will be **no** impact on the calculated figure for GDP when the foreign-owned company sends back to their home country all the profits. GDP measures the value of all production in Tanzania regardless of who owns the productive assets. Thus profits earned by a foreign-owned company in Tanzania are included in GDP. However, the returned profits will be part of net factor income from abroad and will lower the GNP figure.

(iii) An oil spill off the coast costs the Tanzania Government significant clean-up costs.
This **will increase** GDP. The extra spending by the Government on environmental clean-up is added to GDP. GDP does not take into account environmental degradation.

Answer to SEQ 11

(a) 'Double counting' occurs if the expenditure on intermediate goods is included in the calculation of national output. When measuring economic activity using the **output method**, care needs to be taken to distinguish between final and intermediate goods to avoid the problem of double counting. Sometimes it is very difficult to distinguish between intermediate and final goods/To avoid the problem of double counting statisticians could include the final value of all finished goods, with the value of intermediate goods excluded or sum the value added at each stage of production/As a good goes through the various stages of production, it increases in value and it is this increase in value which is included in the national income accounts

(b)

(i) **Gross National Product at Factor Cost**
GNP at Market Prices + Price Subsidies – Indirect Taxes = GNP at Factor Cost
Tshs 200 million + Tshs 5 million – Tshs 30 million = **Tshs 175 million***

(ii) **Net National Product at Factor Cost/National Income**
GNP at Factor Cost – Depreciation = NNP at FC
Tshs 175 million* – Tshs 12 million = **Tshs 163 million**

(c)

(i) **Population changes**
If national income grows at a slower rate than population, then national income per head decreases and the average standard of living will fall. Hence population changes must be considered with changes in national income when assessing a country's economic performance.

(ii) **Inflation/deflation**
An increase in prices will increase national income but standard of living may fall. So, changes in national income must be compared with changes in prices to determine the impact on standard of living / economic performance.

(iii) **Employment / Unemployment**
If a person is unemployed rising national income will not necessarily mean that this person's average standard of living is rising.

(iv) **Levels of taxation**
When considering a person's standard of living one should take into account rates of income tax and levels of indirect tax within the country. An increase in either of these may result in a drop in a person's standard of living.

(v) **Levels of social welfare**
For a person who is unemployed the rates of social welfare payable is of more relevance that the average standard of living in the country.

(vi) **Measures flow of wealth not welfare**
Rising GNP may be accompanied by changing working/living conditions which may cause a loss of welfare e.g. more traffic congestion and so a person's standard of living may fall.

(vii) **Hidden social costs attached to increases in national income.** If a firm increases output national income increases. However, a hidden cost may be increased pollution etc.

(viii) **Distribution of national income.** If increases in national income make their way into the pockets of a small minority, there may be no improvement in the standard of living of the whole community.

(ix) **Exclusion of important activities from calculation of national income.**
The black economy is excluded from the calculation of national income. The work of housewives & voluntary activities is also excluded. Such activities are important to the welfare of its citizens.

(x) **Nature of the goods produced**
A country which spends a small amount on military equipment and a large amount on health, education etc. will have a better standard of living that one where the reverse is the case.

(xi) **Government services at cost price**.
Government services are included at cost while private services are included at selling price. A country where the government provides many services will record a lower GDP / national income

Answer to SEQ 12

(a)

- Gross Domestic Product can be defined as the total output produced by the factors of production in the domestic economy irrespective of whether the factors are owned by Tanzania nationals or foreigners.
- Gross National Product is defined as the total output produced (value of goods and services) by Tanzania owned factors of production in Tanzania and elsewhere. It is a measure of the income accruing to a country's residents.

(b)

- GNP = GDP +Net Factor Income from Abroad (NFIA)
- The net repatriation of profits and the interest repayments on the national debt to non-residents are both outflows hence GDP is consistently and considerably larger than GNP in Tanzania.

(c)

(i) **Population distortions**
Population changes must be considered with changes in national income when assessing a country's economic performance. If national income grows at a slower rate than population, then average income per head may decrease and the average standard of living may fall. Per capita income may be a more meaningful measure of living standards than national income.

(ii) **Constant prices and current prices / Inflation**
An increase in prices will increase national income but the standard of living may fall. So changes in national income must be compared with changes in prices to consider the impact on standard of living / economic performance. GDP calculated at constant prices is a better reflection of economic growth than GDP at market prices.

(iii) **Hidden social costs attached to increases in national income / externalities involved**
If a firm increases output national income increases. However, a hidden cost may be increased pollution etc. Positive and negative externalities such as congestion, waste disposal and attractiveness of areas are excluded.

(iv) **Distribution of national income and poverty**
National Income statistics give headline figures as to the overall economic performance. Further research needs to be undertaken to find how income is distributed. e.g., two countries might have the same level of GNP. However, the income distribution might be very different in both countries with consequences for the welfare of its citizens.

(v) **Shadow economy transactions not measured**
The black economy is excluded from the calculation of national income. The value of unreported transactions is difficult to ascertain thus underestimating the level of national income.

(vi) **Nature of the goods produced**
A country which spends a small amount on military equipment and a larger amount on health, education etc. will have a better standard of living than one where the reverse is the case i.e. much of its wealth is on armaments. There is a large difference in terms of relative economic well-being between the two countries yet the National Income data doesn't reflect this difference.

Answer to SEQ 13

Computation of the national income:

National income (Billions of TZS)

Period Ending	**2008**
Gross national product	**11,059.3**
Net income receipts from rest of the World	55.2
Income receipts	329.1
Income payments	273.9
Gross Domestics Product	**11,004.1**
Private Consumption of fixed capital	1,135.9
Government consumption of fixed capital	218.1
Statistical discrepancy	25.6
National Income	**9,679.7**

Answer to SEQ 14

Calculation of GDP

(i) According to income method

GDP = Wages (W) + Rent (R) + Depreciation (D) + Profit (P)

Wages = (15,000,000 + 10,000,000 + 50,000,000)	= 75,000,000
Rent =	= 2,500,000
Depreciation =	= 7,500,000
Profit = (5,000,000 + 15,000,000)	= 20,000,000
Contribution to GDP	105,000,000

(ii) According to Product Method

GDP	=	Total Sales + Closing Stock of produced – Opening Stock of produced	-	Opening Stock of Intermediate inputs + Purchases – Closing Stock of Intermediate

= Total Output = (Intermediate Inputs + Purchases)

Sales			200,000,000
Changes in finished goods	(17,500,000 22,500,000)	–	(5,000,000)
Changes in Intermediate goods	(15,000,000 5,000,000)	–	10,000,000
Less: Purchase			100,000,000
Contribution to GDP			105,000,000

Answer to SEQ 15

(a) National income accounting is important for the following reasons:

1. It studies where the income is being generated and how it is spent.
2. It helps calculate the total production of final goods and services in the country. Thus, it provides useful insight into how well the economy is functioning.
3. It helps assess the health of the economy by comparing the output per person across countries and across time periods.
4. It helps in assessing the effectiveness of the economic policies of a country.

(b) (i) The government policies influence the GDP and the NI (National Income) of a country in many ways.

Some of these are explained below (Candidates are expected to give examples in each point):

1. **Education and health care policies:** increase investment in this sector contributes in improving the quality of human capital of a country which results in increased production. When production increases, the national income also increases and therefore GDP increases. It is important that a government aims to increase the quality of its workforce by increasing educational and professional training opportunities.
2. **Institutional infrastructure:** improvements in the institutional infrastructure of the country in areas such as law and order, judiciary system, banking and insurance sector and stable and efficient government organizations are important to GDP growth.
3. **Infrastructure policies:** improvement in the physical infrastructure of the country is fundamental to supporting economic activity and encouraging GNP growth. It includes development of roads, railway lines, airlines, bridges, dams, power generation plants etc.
4. **Social policies:** strong policies to reduce unemployment, to control population, to improve social security, to make better education available, to formulate good environmental policies etc. play a vital role in the development of a country's economy and therefore have a significant impact on GNP.

(ii) Limitations of GDP are:

1. GDP does not account for non-market activities. GDP does not include productive activity that does not have a market transaction. For example, unpaid domestic services such as housework, do-it-yourself home improvements etc. are not considered while measuring the GDP.
2. GDP does not account for the value of leisure. Leisure contributes to the quality of life. A country could increase its output (and GDP) if its people worked all seven days of the week. However, having more products might not mean people are better off if they have no leisure time to enjoy them.

Answer to SEQ 16

Given value added taxes = TZS.3,000 Personal tax = TZS.2,000

Depreciation TZS.5,000, Retained earnings = TZS.22,000

GDP_{MP} = TZS.5,000

NNP_{MP} = GDP_{MP} – Depreciation

= 50,000 – 5,000

= TZS.45,000

NNP_{FC} = NNP_{MP} – NIT

= 45,000 – 3,000

= TZS.42,000

Answer to SEQ 17

(i) Gross Domestic Product (GDP) using expenditure approach

GDP = Y = C + 1 + G + NX

Y = 3,657 + 741 + 1,098 + (673 – 704)

Y = 3,657 + 741 + 1,098 – 31

Y = 5,465 billions

(ii) Gross Domestic Product (GDP) using income approach

National Income = Compensation to Employees (Wages) + Rents + Interest + Proprietor's Income + Corporation Profits

National Income = 3,254 + 17 + 530 + 403 + 341 = 4,545

Y = National Income + Indirect Business Taxes + Depreciation + NFFI

Y = 4,545 + 500 + 400 + 20 = **5,465 billions**

(iii) Net Domestic Product (NDP)

NDP = GDP – consumption of fixed capital (i.e. Depreciation)

= 5,465 – 400

= **5,065 Billions**

(iv) National Income at factor cost from the Net Domestic Product (NDP)

National Income at factor cost = NDP at market price – Indirect taxes + Subsidies
= 5,065 – 500 + 15
= 4,580 Billions

Answer to SEQ 18

Three approaches of estimating national income and one limitation for each

- *1st Approach of estimating national income:* Value added/net output approach

  Limitation:

(1) How to account for subsistence output/producers' own consumption. These are goods produced and used by their producers/not exchanged for money. Activities of subsistence sector usually take place outside the market, hence, difficult to establish their monetary values.

(2) Double counting – some firms produce outputs that are used as other inputs by other firms and these other firms in turn produce outputs that are used as inputs by yet other firms.

- *2nd Approach of estimating national income:* Income approach

  Limitation: Focus on items or factors of production, i.e. focuses on the flows of payments of services or primary factors. Hence, excludes some items from income on grounds that they do not add value in a product or service. In other words, the approach is not detailed in terms of production function as 'transfer payment income' such as social security benefits, pension, grants, gifts, relief payment etc. are excluded

- *3rd Approach of estimating national income:* Expenditure approach

  Limitation:

(1) Private consumption does not necessarily depend on market, hence, difficult to estimate national income perfectly.

(2) Difficult to capture spending by non profit making institutions or other informed sectors.

(3) Private expenditure excludes purchases of assets which are not part of current production.

(4) Government output is typically valued at cost rather than at the market value.

Answer to SEQ 19

Way through which governments Policies influences GDP and NI

(i) **Education and health care policies:** increased investment in this sector contributes in improving the quality of human capital of a country which results in increased production. When production increases, the national income also increases and therefore GNP increases. It is important that a government aims to increase the quality of its workforce by increasing educational and professional training opportunities.

(ii) **Institutional infrastructure:** improvements in the institutional infrastructure of the country in areas such as law and order, judiciary system, banking and insurance sector and stable and efficient government organizations are important to GNP growth.

(iii) **Infrastructure policies:** improvement in the physical infrastructure of the country is fundamental to supporting economic activity and encouraging GNP growth. It includes development of roads, railway lines, airlines, bridges, dams, power generation plant etc.

(iv) **Social policies:** strong policies to reduce unemployment, to control population, to improve social security, to make better education available, to formulate good environmental policies etc. Play a vital role in the development of a country's economy and therefore have a significant impact on GNP.

SECTION B

TAX LAWS, ADMINISTRATION AND PRACTICE IN TANZANIA

B1

STUDY GUIDE B1: TAX ADMINISTRATION IN TANZANIA

Get Through Intro

Taxation in Tanzania is administered by the Tanzania Revenue Authority. The Tanzania Revenue Authority (TRA) was established by Act of Parliament No. 11 of 1995, and started its operations on 1st July 1996. In carrying out its statutory functions, TRA is regulated by law, and is responsible for administering impartially various taxes of the Central Government. Other taxes are administered through Local Government Authorities in their respective jurisdictions.

In this Study Guide, we review the historical background of the establishment of Tanzania Revenue Authority, its functions in tax administration, tax administered by the TRA the tax administration provisions relating to tax consultants in Tanzania.

Learning Outcomes

a) Explain the historical background of TRA establishment
b) Explain the functions of the TRA
c) Identify the TRA departments and their roles in tax administration
d) Identify the taxes administered by the TRA
e) Explain the concept of tax compliance
f) Explain the tax administration provisions relating to tax consultants in the Tax Administration Act 2015.
g) Describe Taxpayer's Charter

1. Explain the historical background of TRA establishment; explain the functions of the TRA; identify the TRA departments and their roles in tax administration; identify the taxes administered by the TRA.

[Learning outcome a, b, c and d]

1. The Historical Background Of TRA Establishment

Substantial reform efforts have been made to improve taxation in Tanzania. In 1969 Sales Tax was introduced followed by new Income Tax Act in 1973. The government abolished some excise duty and in 1979 and export duty in 1989. In 1989 the government re-introduced the abolished excise duty. After nearly 30 years of independence, in 1989, the government saw the need to make thorough review of its tax administration establishments and tax structure. There a Presidential Commission was formed to study and review the existing central and local government tax systems and its administration and make recommendations to the government.

The Commission recommended, among other things, the need for widening of tax base, reducing tax rates and introducing Value Added Tax (VAT) to replace sales tax and excise duty. The government implemented the recommendations in the 1992/93 budget and experienced significant fall in tax revenues collections in that year. The major reasons for the fall were noted to be fall in revenues collected through sales and excise taxes and import duties. It was learnt that the rates were reduced without widening the base and the tax administration departments were not strengthened enough to handle the reforms given the short duration. During this time tax administration was under three department of the Ministry of Finance: Sales Tax Department, Customs Department and Income Tax Department; as such, fell within the normal civil service framework.

Due to the noted weaknesses in the tax administration and tax policy formulation, widespread tax aversion, the desire to limit political interference and to free tax administration from civil service constraints, Tanzania Revenue Authority was established through the Act of Parliament in 1995 and became operational in 1 July 1992.

Test Yourself 1

When reviewing the fiscal history of Tanzania, especially between 1989 and 1993, what do you find to be the likely reasons for the establishment of TRA?

2. The Functions Of The TRA

TRA was established on 31st July 1995 as an autonomous agency of the government of Tanzania; it became operational in 1st July1996 under the supervision of the Ministry of Finance and Economic affairs. The general aim of establishing TRA was to bring efficiency in revenue administration and collection.

Since1996TheTanzaniaRevenueAuthorityhasbeenperformingthefollowingfunctionsasprescribedinthe establishment Act -The Tanzania Revenue Authority Act, Section 5(1) (a)):

To implement tax laws in order to assess, collect and account the collected tax revenue;
To ensure effective, fair and efficient administration of union tax laws;
To monitor and ensure the collection of other taxes not collected by it but the revenue is for union government.

To advise the Minister and other relevant organs regarding suitability of fiscal policy;
To encourage voluntary tax compliance;
To increase taxpayers' services given by revenue departments to increase revenues collection;
To take actions against tax evasion and avoidance;
To provide trade statistics and publications on a quarterly basis; and
To perform other functions as direct by the minister of finance.

3. TRA Departments And Their Roles In Tax Administration

Basically there are four main TRA departments responsible in tax administration and management namely; Domestic revenue department, Large Taxpayers department, Customs & Excise department and Tax Investigation department. All the departments are manned by Commissioners who in turn report to the Commissioner General of the Authority.

Large Taxpayers Department

The LTD was formed with the view to administer taxes from large taxpayers. The department has more than 400 taxpayers who contribute around 70% of domestic revenues

Domestic Revenues Department

The integration of VAT and Income Tax Departments was implemented in July 2005 whereby the DRD was formed. The department administers taxes from medium and small taxpayers. It accounts for about 30% of the domestic revenue.

Customs and Excise Department

The department administers international trade taxes and accounts for 42% of total TRA collections.

Tax Investigation Department

The department responsibility is to minimize the occurrence of tax fraud through identification and investigation of fraudulent cases, collecting evaded taxes and recommending prosecution of offenders with a view to improve compliance with tax laws.

4. Taxes Administered By The TRA

TRA administers Central Government taxes. These include:

1.2 Income Tax

Income Tax is charged and paid in varieties of ways as indicated below:

Individuals Income Tax: Individuals are categorized in three groups, **small individual traders** who are not required to maintain audited accounts, the **medium individual traders** who are required to maintain audited accounts and **employees**. Small traders are taxed by presumptive tax system, medium sized traders are taxed based on the annual profit determined from the audited accounts and employees are taxed through Pay As You Earn (PAYE) tax system. It is a withholding tax on taxable incomes of employees. Under this system, an employer is required by law to deduct income tax from an employee's taxable salary or wages.

Corporations Tax: Corporation Tax is a tax charged on the taxable incomes (profits) of entities such as limited companies and other organizations including clubs, societies, associations and other unincorporated bodies.

Withholding Taxes: Withholding tax is the amount of income tax retained by payer when making payments to another person (payee) in respect of goods supplied or services rendered by the payee.Withholding taxes is applicable for certain specific type of payments mentioned in S.81, 82 and 83 of Income Tax Act 2004. PAYE above is an example of withholding tax.

Capital Gain: This is a tax charged on gains made when a person realizes an interest in land or buildings. A person is treated as realizing an interest in an asset when the person parts with ownership of such interest including when it is sold, exchanged, transferred, distributed, cancelled, redeemed, destroyed or surrendered and in the case of interest of an entity when it ceases to exist, immediately before the entity ceases to exist.

1.3 VAT

It is a consumption tax charged on taxable goods, services immovable property of any economic activity whenever value is added at each stage of production and at the final stage of sale. VAT is charged on both locally produced goods and services and on imports.

1.4 Excise Duty

Excise Duty is a duty charged on specific goods and services manufactured locally or imported on varying rates. It is charged in both specific and ad valorem rates. Items charged include: Wine, spirits, beer, soft drinks, mineral water, fruit juices, Recorded DVD, VCD, CD and audio tapes, cigarettes, tobacco, petroleum products and Natural gas, money transfer services, electronic communication services, pay to view television services, imported furniture, motor vehicles, plastic bags, specified aircrafts, firearms, specified cases, cosmetics and medicaments.

1.5 Stamp Duty

All chargeable instruments by any person in Tanzania Mainland shall be stamped. An instruments is defined as to include every document by which any right or liability is, or purports to be, created, transferred, limited, extended, extinguished or recorded. Instruments that attract stamp duties include: affidavit, cheque, valuation, power of attorney, agreement or memorandum of agreement, lease documents, transfers of shares, transfer of debentures etc.

1.6 Gaming Tax

The Gaming tax is charged on six types of gaming activities namely Casinos, Sports Betting, SMS Lottery, National Lottery, Slots (Route) Operations and Forty Machines Site.

1.7 Skills Development Levy

Skills Development Levy is charged at 4.5% of gross emoluments made by the employer to the employees employed by such employer in the particular time.

1.8 Customs Tariffs

This includes tariffs (import duty) on goods imported from non-East African Community member states as well as export tariffs.

1.9 Motor Vehicle Registration, Transfer and Licensing Fees

The TRA is responsible to collect tax when a motor vehicle is first registered in Tanzania, transferred from one owner to another in Tanzania, and annual licensing fees.

2. Explain the concept of tax compliance; explain the tax administration provisions relating to tax consultants in the Tax Administration Act 2015 and describe Taxpayer's Charter.

[Learning outcome e, f and g]

5. The Concept Of Tax Compliance

Tax compliance means complying fully with the requirements of tax laws by reporting and paying the correct amount of tax on time.

Aspects of tax compliance

Filing various returns and documents by the statutory due dates

(a) Accompanied by reporting correct income or tax due.
(b) Avoid understatement.

- Payment of the correct tax on or before the statutory due dates.
    - Filing without payment is not sufficient.
- Tax avoidance , mitigation and planning form compliance
    - Should be discouraged by setting accurate legal provisions

Types of Tax compliance

- Voluntary compliance;
- Forced/Involuntary compliance

Voluntary Compliance: Situation where by taxpayers and their advisors faithfully abide by the requirements of the tax laws without compulsion.

Benefits:

- Saves the government the costs of revenue collections.
- Promotes the realization of the tax policy , i.e non – revenue goals;
- Guarantees/ensure steady flow of revenue for development.
- Taxpayers avoid unnecessary penalties.

Forced tax compliance

The Tax Administrator calculates the tax liability of the taxpayer and informs him, according to which the taxpayer pays the tax

Less superior to voluntary compliance, and may result into high cost of tax administration.

Achieving maximum voluntary compliance

- Education to taxpayers through interview; radio, TV's seminars/ workshops/ training; publication, etc.
- Assist the tax payers, e.g tax consultant may assist in the completion of the returns, identifying the due dates and related penalties, etc.
- Cooperation of other government agencies, departments, ect.

6. Tax Administration Provisions Relating To Tax Consultants In The Tax Administration Act 2015.

The Tanzanian Tax system is a self-assessment one where taxpayers are obliged to self-declare their taxable activities and pay tax accordingly. However experience show that self – assessment, is not a simple straight forward affair, the complexity of tax legislations and even the time required to file various returns by tax payers, they are given the option of filing a return with the assistance of a tax consultant. The most common role of tax consultants is to help people prepare and file their tax returns. This can be a valuable service, as failing to do so properly can leave a taxpayer liable to paying penalties.

Definition

Tax Consultants (or professional, practitioner, advisor) is a person recognized by TRA as sufficiently qualified to provide professional service consistent with tax legislation.

A person shall not practice or (in return of a payment) hold out to be an Income Tax Consultant unless the person is an approved tax consultant. The provision prohibits any person, including authorized accountants, or auditors to practice as tax consultants until the Commissioner for domestic revenue legally registers such person. Indeed TRA exercises elaborate oversight functions on tax consultants. Tax consultant's duties include representing taxpayers before a tax administration concerning tax payers' rights, privileges or liabilities and preparing documents to be filed before the tax Authority. In order to ensure that tax practitioners' are capable of playing the role expected of them, their conducts is typically regulate under the law in different countries.

1.10 Registration

A person shall not practice as a Tax Consultant unless that person has been registered as a tax consultant by the Commissioner General. The individual shallbe registered and approved to offer his services after a successful application to the Commissioner General. The application shall be made by filling aprescribed form and payment of the prescribed fees.

Tip

An entity cannot be registered as a tax consultant. Only individual may be registered. Registered individual(s) on behalf of entities take(s) full responsibility for the misconducts of other tax consultants of the entity as well as other employees of the entity.

Minimum Registration Requirements

The Commissioner General shall register every person who has made an application and meets the following conditions:

Academic qualifications

Bachelor: The applicant shall be a holder of a degree in accountancy, finance, financial management, commerce, economics, customs and tax management or laws awarded by any university or other recognized institution of higher learning

Postgraduate: Where the applicant does not hold the above bachelor degree, then he/she needs to hold a postgraduate diploma in tax management or equivalent qualification as may be recognized by the Commissioner General.

Tax Expertise and Professional Conduct

The applicant shall also be a person of good reputation, has sufficient knowledge and experience with matters regulated under tax laws, his professional and general conduct render him fit and proper person to be registered.

For purpose of assessing an applicant's qualifications and expertise, the Commissioner General may require the applicant to take an examination or other forms of assessment.

Approval and Registration

The Commissioner shall grant an applicant an approval as a tax consultant within thirty days from the date of receipt of application. The approval as a tax consultant issued shall expire after a period of two years from the date of approval, and may be renewed. A person registered and approved as tax consultant shall be issued with a certificate of registration and approval as the case may be.

1.11 Deregistration

The Commissioner General shall deregister any tax consultant upon:

- occurrence of the **death** of the tax consultant;
- a tax consultant tendering a **resignation** to cease to practice as a tax consultant;
- **leaving the country** without an intention to return to the United Republic;
- conviction of a **criminal offences** carrying a maximum penalty of a fine of not less than thirty five currency points or imprisonment;
- becoming **bankrupt**;
- **expiry** of approval of the tax consultant without being renewed;
- occurrence of gross **professional misconduct** by the tax consultant;
- the Commissioner General receiving **recommendation** of the Committee of the Inquiry under regulation 12(6)(c); or
- **Breaching** any of the **conduct and behavior** of tax consultants

1.12 Conduct and Behavior of Tax Consultant

A tax consultant shall, provide quality services to clients so as to enable them to comply with the provisions of any tax laws and regulations made thereunder, and in so doing shall specifically:

a) when handling clients affairs, be well **mannered, honest, sincere and truthful** and shall furnish the Commissioner General or other officers of the Tanzania Revenue Authority with such information as to the best of his knowledge and belief, is correct;
b) refrain from using information acquired in the course of practicing as a tax consultant to the personal advantage of the tax consultant or any of his associate;
c) advise clients accurately and in a timely manner on the progress of their tax affairs;
d) use funds entrusted to him by clients only for the purposes for which the funds were provided, and provide clients with appropriate receipts and evidence of expenditure including proof of payment of tax, on a timely basis;

e) refrain from entering into any arrangement whereby the consultant authorizes tax advice prepared by another person other than an employee of the consultant;
f) exhibit a high degree of skill and professional competency, including high level of conversancy with tax laws and tax practice and ensure that the tax consultant's technical knowledge is kept up to date;
g) to the best of the consultant's ability, ensure that all returns and tax computations submitted to the Tanzania Revenue Authority are properly completed, with required supporting statements and schedules, and that such submissions are in compliance with the law;
h) take cases and advise clients with respect to matters that are within the consultant's experience and competency;
i) when making appeals against any tax decision, take proper care to ensure that such appeals are based on valid grounds;
j) educate clients on the importance of maintaining proper records of all transactions, especially clients engaged in business;
k) advise clients of the necessity to make sufficient provision for the payment of tax as well as the importance of keeping to installment plans for the payment of tax so as to avoid late payment interest and penalties;
l) quote the consultant's registration number on all correspondence with the Commissioner General;
m) avoid express an opinion or permit the consultant's name to be used with respect to a tax matter unless the consultant (or an employee under the direct supervision of the consultant) has been appropriately instructed by the client;
n) be personally responsible for the actions of any employees of the Consultant in providing tax services to clients;
o) keep and maintain a register in which the name of every client is recorded together with-
   i] the client's Tax Identification Number;
   ii] the client's home or business address as well as the client postal address;
   iii] the date the person became a client;
   iv] the due dates for submission of the client's return or any other statements or documents;
   v] the due dates for payment of tax and dates when tax is paid;
   vi] consultancy fees charged to and paid by the client; and
   vii] such other information as the Commissioner General may specify by notice in writing; and
p) Inform the Commissioner General in writing when the consultant ceases to act for a particular client, including the client's name and Taxpayer Identification Number.

7. Taxpayer's Charter

The Taxpayer's Charter is a document developed by the TRA in close cooperation and consultation with its stakeholders and clients. The Charter addresses the fundamental rights and obligations of the taxpayer and the TRA in fulfillment of its responsibility of enhancing awareness and promoting equity and fairness to all taxpayers.

7.1 Taxpayers' rights

The Charter states in simple language the general rights of a taxpayer and those under the tax law. The rights identified include the following:

1. Impartial treatment

Taxpayer has a right to an impartial application of the tax laws when fulfilling his/her tax obligation, so as to enable the taxpayer pays the required amount of tax.

2. Privacy and Confidentiality

Taxpayer has a right to privacy and confidentiality for private and business information supplied to TRA unless the law allows the exposure of such privacy and or confidentiality.

3. Presumption of Honesty

The taxpayer has a right to be presumed honest unless evidence to the contrary exists.

4. Objection of Tax Assessment

Taxpayer has a right to object to an assessment or any other decision made by TRA to the extent of which that right is restricted by the law.

5. Tax incentives and Exemption under the Tax Laws

Taxpayers have the right to plan their tax affairs so as to obtain incentives and exemption allowed under the tax laws. TRA shall apply the tax laws in a consistent manner to all taxpayers.

7.2 Taxpayers' Obligations

The Charter considers that paying tax is a civic obligation of every citizen/person and therefore sets out responsibilities that must be adhered to by taxpayers as follows:-

1. **Registration**

   If the person is eligible to pay any of the taxes administered by TRA and has not been registered by any of the revenue departments, has an obligation to register himself with TRA.

2. **Filing Returns and Payments**

   It is the obligation of every person who is registered for Income Tax, VAT, and other taxes administered by TRA to file a tax return within the period stipulated under the respective Acts and accompany the return with tax payments due.

3. **Accuracy of Returns, Entries and Refund Claims**

   When filling tax returns, lodging a refund claim or making a declaration for any imported goods, taxpayers have an obligation to ensure that the returns claims and declarations represent full and true disclosure of the transactions for the period covered.

4. **Timely Payment of Taxes**

   Taxpayers have an obligation to pay taxes promptly as they fall due so as to avoid unnecessary penalties and interests under the tax laws.

5. **Cooperation with TRA officers**

   Taxpayers have an obligation to give TRA employees adequate cooperation by disclosing or producing all relevant information or documents required by them. Taxpayers are also obliged to accord them with their due respect and freedom to carry out their lawful duties and they should not intimidate, abuse, threaten or influence them in any manner whatsoever, whether financial or otherwise.

   Conversely TRA employees shall be courteous, polite, service-oriented and not arrogant, harassing and authoritarian. Taxpayers have the right to report to higher authorities any departure from the norms of a good tax administrator.

7.3 Problems Associated With The Enforcement Of Taxpayers' Rights

1. **Lack of Professional Experts**

   Since tax law is a developing area in Tanzania, there are few experts on tax matters. As a result taxpayers do not get timely advice on their tax obligations and do not know when and how their rights are violated.

2. **Lack of Tax Education and Ignorance of Tax Rights**

   Most taxpayers are not aware of their tax obligations and rights due to lack of massive tax education in this country. As a result, most taxpayers are not aware of their tax rights and obligations. At the same time, they do not fully appreciate the importance of taxes. All these culminate into taxpayers not knowing how to enforce their tax rights.

3. **Inefficient Investigation Procedures**

   The procedures of investigating and following up of taxpayers complaints in Tanzania are slow and poor. This leads to dragging in handling of tax cases

2 Answers to Test Yourself

Answer to TY 1

The Presidential Tax Commission had several recommendations on the restructuring of the tax system of the country. These recommendations were started to be implemented in FY 1992/93, a year after the Commission's report. The time span required to prepare the taxation departments to undertake the recommendations with efficiency was too short. That's partly why the revenues declined in 1992/93 FY. The tax administration during the time also proved to be very inefficient due to widespread tax evasion and lacked independence from political interference as the departments were sections in the Ministry of Finance. Therefore, establishment of effective and efficient tax administration organ which will be independent from the political interference was initiated and Tanzania Revenue Authority was later enacted in 1995.

Self-Examination Questions

Question 1

What are the minimum conditions for registration of an individual as a tax consultant?

Question 2

What are the tax administration duties of the four functional departments of the TRA?

Question 3

Tanzania Revenue Authority (TRA) was established on 31st July 1995 as an autonomous agency of the government of Tanzania; it became operational on 1st July 1996 under the supervision of the Ministry of Finance. The general aim of establishing TRA was to bring efficiency in revenue administration and collection.

Required:

Analyse the role of the Tanzania Revenue Authority (TRA

Answers to Self-Examination Questions

Answer to SEQ 1

The minimum registration conditions include a bachelor degree in business related studies, economic or law; or a postgraduate diploma in taxation. Also an applicant shall provide proof of reasonable expertise/experience in taxation and good reputation and professional conduct.

Answer to SEQ 2

The four main TRA departments are Domestic revenue department, Large Taxpayers department, Customs & Excise department and Tax Investigation department. Large Taxpayers Department administers taxes from large taxpayers. Domestic Revenues Department administers taxes from medium and small taxpayers. Customs and Excise Department administers international trade. Tax Investigation Department responsibility is to minimize the occurrence of tax fraud through identification and investigation of fraudulent cases, collecting evaded taxes and recommending prosecution of offenders with a view to improve compliance with tax laws.

Answer to SEQ 3

TRA was established on 31st July 1995 as an autonomous agency of the government of Tanzania; it became operational in 1st July 1996 under the supervision of the Ministry of Finance and Economic affairs. The general aim of establishing TRA was to bring efficiency in revenue administration and collection. Since 1996 the Tanzania Revenue Authority has been performing the following roles as prescribed in the establishment Act – The Tanzania Revenue Authority Act, Section 5(1)(a):-

(i) To implement tax laws in order to assess, collect and account the collected tax revenue;
(ii) To ensure effective, fair and efficient administration of union tax laws;
(iii) To monitor and ensure the collection of other taxes not collected by it but the revenue is for union Government.
(iv) To advise the Minister and other relevant organs regarding suitability of fiscal policy;
(v) To encourage voluntary tax compliance;
(vi) To increase taxpayers' services given by revenue departments to increase revenues collection;
(vii) To take actions against tax evasion and avoidance;
(viii) To provide trade statistics and publications on a quarterly basis; and
(ix) To perform other functions as directed by the minister of finance.
(x) Goals/objectives of TRA may also be accommodated when mentioned.

SECTION B

TAX LAWS, ADMINISTRATION AND PRACTICE IN TANZANIA

B2

STUDY TEXT GUIDE B2: SOURCES AND INTERPRETATION OF TAX LAWS

Get Through Intro

The tax administration in any country shall be governed by law. Therefore, a person shall not be charged tax unless there is a clear legal provision requiring the person to be charged such tax. In other words, a tax charge must be established by law.

In this Study Guide we review the sources of tax laws i.e. where we can derive the legal rulings related to tax chargeability and tax administration in general. The Guide will also introduce the doctrines followed in interpreting these legal provisions.

Learning Outcomes

a) Describe the different sources of Tax Laws in Tanzania
b) Identify the general rules for interpretation of tax laws

Describe the different sources of Tax Laws in Tanzania; and identify the general rules for interpretation of tax laws.

[Learning outcome a and b]

1. The Different Sources Of Tax Laws In Tanzania

The sources of income tax laws are the following:

1. Statutes

A statute is a formal written enactment (act) of a parliament of a particular state governing various taxation for that state. It is a primary authority on matters of income tax, yet must be constitutional. In Tanzania, tax statutes are made up of both the principal legislations and the subsequent Finance Acts which amends the principal legislation from time to time. Usually the Finance Acts are passed during the annual parliamentary budget sessions.

Tanzania Tax Statutes

The following are tax statutes applicable in Tanzania:

Tax Administration Act 2015
Income Tax Act Cap. 332 Revised Edition 2008
The Value Added Tax Act, 2014
The Port Service Charges Act Cap 264
The Motor vehicle (Tax Registration and Transfer) Act cap 124
The Airport Service Charges Act Cap 365
The Road and Fuel Toll Act Cap.220
The Stamp Duty Act Cap. 189
The East African Community Customs Management (Amendment) Act, 2011
The East African Community Customs Management Act, 2004 (Revised)
The Gaming Act, Cap. 41
Vocational Education And Training Act, Cap. 82
The Foreign Vehicle Transit Charges Act, Cap.84
The Tax Revenue Appeals Act Cap. 408
The Hotels Act Cap. 105
The Tanzania Revenue Authority Act Cap.399
The Oil and Gas Revenues Management Act, 2015
The Urban Authorities (Rating) Act, CAP 289

2. Regulations

The principal legislation allows the Minister responsible with tax administration [in this case, the Minister of Finance] to prepare regulations where necessary as additional provisions with respect to tax laws for the better implementation of the principles, purposes and provisions of the principal Acts. The regulations usually carry the same authority as that of the principal act.

Tanzania Tax Regulations

The Tax Administration (General) Regulation, 2016
The Income Tax Regulation
The income Tax (Transfer Pricing) Regulations, 2014
Transfer Pricing Guidelines
The Value Added Tax (General) Regulations, 2015
EAC Customs Management (Duty Remission) Regulations, 2008
EAC Customs Management Regulations, 2010

EAC Customs Management (compliance and enforcement) Regulations, 2012
The excise (Management and Tariff) The Films and Music Products (Tax Stamps) Regulations 2013
GN No 218 of 2012 - Tourism Development Levy
Road Traffic (Motor Vehicles Registration) Regulations
The Road Traffic (Motor vehicle Registration) (Amendments) Regulations, 2014
Tax Administration General Amendment Regulations 2017
The Electronic Revenue Collection System 2017

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3. Practice Notes
The Commissioner responsible with tax administration is allowed by the respective principal Acts to prepare practice notes to achieve consistency in the administration of the principal act and to provide guidance to persons affected by it. The practice notes usually carry the same authority as that of the principal act.

4. Case Laws
These are sets of rules of law which have been established based on previous court cases. Basically, previous courts' decisions set precedence that may be used to judge subsequent similar cases. Where a legal case is decided today (by the High Court or Court of Appeal), it becomes an authority over which similar subsequent cases, presided in any other court of law or tribunal in that particular jurisdiction, may be decided on the authority of such previous case.

Test Yourself 1

Differentiate between a Regulation and a Principal Act

2. General Rules For Interpretation Of Tax Laws

Taxation, even fair taxation, is a pervasive form of state interference in the lives of individuals. Yet, it must happen. Therefore, in the taxation process, the government should operate under the law and citizens should be able successfully to plan and organize their lives within the law, by deriving guidance from the law itself. This requires the taxpayer, or his agent, to have the ability to interpret and derive the meaning intended by tax laws. The courts, in that regard have developed different interpretation doctrines in interpreting fiscal legislations. Each one has its own strengths and weaknesses.

Doctrines of tax laws Interpretation

i] Strict Construction
ii] Purposive Approach
iii] Plain Meaning Rule
iv] Words – in Total – Context - Approach

2.1 Strict Construction
Strict Construction doctrine requires that tax statutes be construed literally and strictly i.e. should not be subject to interpretation, but applied strictly as written. This means that, under strict constructionism, there is no room for considering the context in which the law was made, any legislative purpose or spirit other than the raising of revenue, or taking into account the specific circumstances of any individual case. Therefore, any ambiguity in a provision charging/imposing a tax charge should be resolved in favor of the taxpayer; while any ambiguity in a provision setting out deductions or exemptions should be resolved against the taxpayer.

Notwithstanding the dominance of strict construction some judges took different approaches:

1. Objects and Intentions
For some judges, tax statutes should, like other statutes, be interpreted according to the object or purpose of the statute and the intention of the legislature.

2. Contextual Analysis
Other courts rejected the narrow literalism of strict construction in favour of a contextual approach to the interpretation of statutes language. In this case, judges adhere to the literal construction unless the context renders it plain that such a construction cannot be put on the words.

3. Golden Rule
The third alternative to strict construction is the Golden Rule. It stipulates that courts can depart from the literal words of a statute to avoid the absurdity and inconsistency but no father.

2.2 Purposive Interpretation
In contrast to strict construction, purposive interpretation emphasizes the reasons for which the statutory text was enacted and the objectives at which it aims, and interprets the text in light of these reasons and objectives. The purposive interpretation **begins with the objectives** underlying the statutory text and the reasons for which it was enacted, **and interprets the text** in light of these objectives and reasons.

2.3 Plain Meaning Rule
While purposive interpretation begins with the objectives underlying the statutory text and the reasons for which it was enacted, and interprets the text in light of these objectives and reasons, the plain meaning rule to statutory interpretations begins with the words of the text, which are to be given their ordinary or literal meaning unless they are ambiguous, in which case the court may then consider the scheme of the Act, the object of the Act and the intention of the Parliament in order to resolve the ambiguity.

The plain meaning of a statute is the “ordinary or natural meaning.” By natural meaning, it is meant a commonsense meaning. By ordinary meaning it is meant an idiomatic sense that is the same way that ordinary people in common usage might speak or use the word.

Test Yourself 2

Differentiate between Strict Construction and Plain Meaning Rule doctrines

2.4 Words–In–Total Context Approach
The words in total context approach affirms a more pragmatic view, according to which the meaning of a statutory provision is best understood by reading the words of the provisions in their entire context, harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament.

2.5 The Best Approach
The Australian High Court has synthesized all the doctrines; in the case of **Cooper Brookes (Wollongong) Pty Limited Vs Commissioner of Taxation [1980] 147 CLR 297**; into the following principles:

- The fundamental rule of interpretation is to ascertain what the parliament intended as expressed in the words it has used;
- Context is vital. Sections are not to be construed in isolation
- Where the language of a statute is clear and unambiguous and consistent with the context it must be given its ordinary and grammatical meaning, even if the result is incontinent.
- Where two constructions are open the court will prefer the construction that avoids inconvenience or injustice.
- Where the literal meaning of words is to be deported from it must be clear that the literal meaning does not give effect to the intention of the legislature that a departure from the literal meaning will.
- The literal meaning will be departed from where it gives rise to an operation that is capricious or irrational.
- The Court cannot construe a provision, in a manner, which violates the Constitution.

3 Answers to Test Yourself

Answer to TY 1
The principal legislation and the Act have the same effect, however they are different. The principal legislation refers to written statutes passed by the parliament that govern a particular subject e.g. income taxation. On the other hand the regulations refer to standards and rules set-up by the Minister showing how the principal legislation shall be enforced. Its provisions when read holistically indicate the context and objectives of the law. For the Minister to have legal grounds to institute regulations, the principal legislation shall provide for it.

Answer to TY 2
The Strict Construction doctrine relies on the literal meaning of words to interpret the provisions of law. It ignores the context, objects of law and intentions of the parliament. The Plain Meaning Rule, on the other hand, considers both the ordinary meaning of the text as well as the context of the matter, objectives of the law, and the intentions of the parliament in interpretation of the law. However, the Plain Meaning Rule provides precedence to the ordinary and natural meaning of the text unless it is ambiguous in which case the court shall consider the context, objects of the law and intention of the parliament to get the meaning out of laws.

Self-Examination Questions

Question 1
Explain the differences between the four doctrines for interpretation of tax laws by focusing on how they give preference to wording of the text on one hand and context, objects of the law and intention of the parliament on the other hand.

Question 2
Briefly explain the principles for interpretation of tax laws derived from the case of ***Cooper Brookes (Wollongong) Pty Limited vs. Commissioner of Taxation [1980] 147 CLR 297*** presided in the Australian High Court.

Answers to Self-Examination Questions

Answer to SEQ 1
Strict Construction gives precedence to literal meaning of words of the law and completely ignores the context, objects of the law and intention of the parliament.

Purposive interpretation gives precedence to the context, objects of the law and intention of the parliament. Therefore, it interprets word of the law in light of the context, objects of the law and intention of the parliament.

Plain meaning rule gives precedence to the ordinary meaning of the words of the law but consider the context, objects of the law and intention of the parliament where the ordinary meaning of the words is ambiguous.

Words-in-total context approach gives precedence to both wording and the context, objects of the law and intention of the parliament.

Answer to SEQ 2

The Australian High Court has synthesized all the doctrines; in the case of Cooper Brookes (Wollongong) Pty Limited Vs Commissioner of Taxation [1980] 147 CLR 297; into the following principles:

- The fundamental rule of interpretation is to ascertain what the parliament intended as expressed in the words it has used;
- Context is vital. Sections are not to be construed in isolation
- Where the language of a statute is clear and unambiguous and consistent with the context it must be given its ordinary and grammatical meaning, even if the result is incontinent.
- Where two constructions are open the court will prefer the construction that avoids inconvenience or injustice.
- Where the literal meaning of words is to be deported from it must be clear that the literal meaning does not give effect to the intention of the legislature that a departure from the literal meaning will.
- The literal meaning will be departed from where it gives rise to an operation that is capricious or irrational.
- The Court cannot construe a provision, in a manner, which violates the Constitution.

STUDY TEXT GUIDE B3: TAX AVOIDANCE AND EVASION

Get Through Intro

For many years individuals have found imaginative ways of avoiding liability to tax. Large companies employ highly skilled tax planners in a bid to legally reduce their overall tax liability. There have been many instances of individual's under-declaring their income to reduce their tax liability. The question here is whether these activities constitute tax avoidance or tax evasion.

Learning Outcomes

a) Differentiate between tax avoidance and evasion
b) Explain main causes of tax avoidance and evasion
c) Identify general practices through which a taxpayer can eliminate or minimize tax liability through tax avoidance and evasion
d) Explain the ways that can be employed to minimize tax avoidance and evasion
e) Discuss statutory measures against tax avoidance in Tanzania
f) Describe judicial anti-avoidance doctrines (Business purpose rule, substance over form principle, sham transaction, step transaction doctrine etc)

1.0 Differentiate between tax avoidance and evasion; explain main causes of tax avoidance and evasion; and Identify general practices through which a taxpayer can eliminate or minimize tax liability through tax avoidance and evasion.

[Learning outcome a, b and c]

1. Differentiate Between Tax Avoidance And Evasion

Tax evasion is a deliberate act by an individual or company to mislead, misinform or otherwise mis-state their tax position to the Tanzanian Income tax authorities in order to evade taxes. **Tax evasion is illegal** and is punishable by hefty fines and imprisonment.

Tax avoidance is legal. It involves the arrangement of individuals' or companies' tax affairs in a way which reduces the tax liability. For example, using incentivized tax savings schemes OR establishing an offshore company in a tax haven or by forming a limited company to avail of more favourable tax deductions.

Tax incidence can be reduced through tax avoidance or tax evasion. Tax evasion and avoidance are pervasive in all countries worldwide and tax systems are striving towards reduction.

1.1 Tax evasion

Tax evasion involves efforts by individuals, firms, trusts and other entities to evade the payment of taxes by breaking the laws. It is an intentional and fraudulent attempt to escape payment of taxes in whole or part.

Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting (such as under declaring income, profits or gains; or overstating deductions).

1.2 Tax avoidance

Tax avoidance is the legal exploitation of the tax region to one's own advantage to attempt to reduce the tax payable using means that are within the law while making a full disclosure of the material information to the tax authorities.

Tax avoidance is any legal way of reducing the amount of tax payable – involving a sensible arrangement of the taxpayers' affairs so as to minimise the liability to tax. All activities must remain legal at all times. It is the utilisation of "tax loopholes" within the legislation in an ingenious way, thereby affording the tax payer, legally, a favourable tax position.

Sometimes avoidance is considered as amoral dodging of one's responsibilities to society or right of every citizen to find all the legal ways to avoid paying too much tax.There is no moral obligation to paying maximum tax. One is supposed to pay not more and not less than what the law says. Examples of tax avoidance are: tax deductions, changing one's business structure through incorporation, or establishing an offshore company in a tax haven. (Ref. IRC v. Duke of Westminster (1936) 19 TC 490, 1936AC1; Ayshire Pullman Motor Services and Rirchie v. IRC (1929) 14 TC 754)

Definition

Tax resisters are the ones who refuse to pay tax because they do not want to support the government or some activities carried out by the government and sometimes breaking the law do so-hence practicing tax evasion.

Some tax resisters may donate their unpaid tax to charities and/or some make creative deductions; their basis for resisting is not against the tax laws, neither are they motivated by the derive to keep their money. The issue is they don't want to pay for what they oppose (e.g. against huge defense budget)

Definition

Some have suggested **tax avoidance** for people who adopt the tax avoidance techniques in the service of tax resistance – thereby doing tax resistance legally-hence practicing tax avoidance.

1.3 Differences between tax evasion and tax avoidance
Essentially, the difference between tax avoidance and tax evasion is legality.

Tax avoidance is legally exploiting the tax system to reduce current or future tax liabilities by means not intended by parliament. It often involves artificial transactions that are contrived to produce a tax advantage.

Tax evasion is illegal crime in almost all countries and subjects the guilty party to penalties such as fines or even imprisonment while tax avoidance is not punishable.

2. Main Causes Of Tax Avoidance And Evasion

General causes of tax avoidance and evasion are:-

i) High marginal tax rates and frequent changes in tax rates.
ii) Administrative inefficiency, collusion with taxpayers and bribery of tax officials.
iii) Inadequate training and experience of tax administrators coupled with lack of exposure to business practices may limit their abilities to analyze complex issue, e.g international schemes.
iv) Multiplicity of taxes
v) Low prospect of detection and punishment.
vi) Wasteful manner in which the revenue is spent and lack of clear benefits to taxpayers through improved social services.
vii) Deficiencies in the legal structure of the tax laws and complexity which allow tax avoidance.
viii) Traditional and culture tendency to hate and evade tax (low tax morality)

3. General Practices Through Which A Taxpayer Can Eliminate Or Minimize Tax Liability Through Tax Avoidance And Evasion

3.1 Tax Evasion Methods
Tax payers may evade tax through the following practices:

i] Tax payers may avoid tax by making a false return of income by omitting income or overstating expenses.
ii] Tax payers also evade tax by preparation or maintenance of false books of accounts or records. This may involve manipulation of stock sheets and valuations, destruction of or defacing of accounting records, non-issue of sales receipts etc.
iii] The importers purport to evade customs duty by (a) under-invoicing and (b) mis-declaration of quantity and product-description. When there is ad valorem import duty, the tax base is reduced through under-invoicing. Mis-declaration of quantity is more relevant for products with specific duty.
iv] Smuggling is importation or exportation of foreign products through unauthorized route. Smuggling is resorted to for total evasion of leviable customs duties as well as for importation of contraband items.
v] Traders who collect VAT from the consumers may evade tax by under-reporting the amount of turnover.

Tax Avoidance Mechanisms

Tax avoidance is usually practiced through the following practices:

i] Transfer Pricing
This is an economic term which refers to the valuation process for transactions between related entities/persons. Improper transfer pricing methods lead to unjustified profit transfers. For example, artificially deflated or inflated prices on transactions would reduce or increase the taxable profits of associated companies.

ii] Income Splitting
This entails the splitting of income between more than one taxpayer so as to reduce the marginal tax rate. If you can manage to split one figure into several the applicable marginal tax rate will be lower and therefore little taxable income.

iii] Thin Capitalization
The term “Thin Capitalization” is commonly used to describe “hidden equity capitalization” through excessive loans. It is the artificial use of interest – bearing debt instead of equity by shareholders with the sole or primary motive to benefit from its tax advantages. The loan may be provided on a market rate of interest but the size of the loan cannot be justified on bona fide business considerations. Such excessive interest payments constitute hidden distributions that should be properly treated as dividend on equality capital.

iv] Asset Shifting
This is achieved by shifting the asset producing income to another person or entity that is taxed preferentially, i.e. is taxed less than the person shifting the asset, e.g. Company vs. Trust.

v] Sheltering of Income
This is done by receiving incomes in tax havens Jurisdiction. These are jurisdictions with lower tax rates or no tax charge at all.

vi] Income Capitalization
This means the conversion of taxable income into capital, e.g. dividends are not declared but put available as capital.

2.0 Explain the ways that can be employed to minimize tax avoidance and evasion; discuss statutory measures against tax avoidance in Tanzania; an describe judicial anti-avoidance doctrines
[Learning outcome d, e and f]

4. Ways That Can Be Employed To Minimize Tax Avoidance And Evasion

i) Keep the marginal tax rates low, realistic and not subject to frequent changes.
ii) Promote administrative efficiency, e.g by providing better tools, motivating staffs, etc.
iii) Technical staff training, e.g tax laws; accountancy, exchange visits with other countries.
iv) Avoid multiplicity of taxes by retaining the major taxes only.
v) Serious punishment to evaders and corrupted tax officials.
vi) Judicious expenditure of revenue by the government because where tax monies are well spent, may improve voluntary compliance.

5. Statutory Measures Against Tax Avoidance In Tanzania

In order to reduce tax avoidance practices, tax laws in Tanzania have come up with the following measures:

i] Specific Provisions: The Income Tax Act, 2004 ss. 27 – 35 enact specific provision that identify with precision the type of transactions to be dealt with and prescribe against the tax consequences of such treatment.
ii] General Provisions: the enactment of general provisions to hit broad types of avoidance practices in specific areas
iii] Arm’s Length Approach – the transactions between related parties should be similar to transactions between independent parties. see s. 33(1) of ITA.

iv] Administrative Approach – there possibility to control tax avoidance is left to the discretion of the tax authority. see s. 33(2); 34(1); 35(1).

6. Judicial Anti-Avoidance Doctrines

Courts have stated certain principles intended to curb tax avoidance. They have stated doctrines or General Anti-Avoidance Rules (GAAR). Three main guiding principles are:-

(a) *The Business purpose Rule*.

(b) The substance or form rule.

(a) The Business Purpose Rule:

The business purpose rule attacks tax avoidance schemes that do not have a business purpose and those artificially designed merely to avoid tax. Under the business purpose doctrine, a transaction must have a main or predominant business purpose (i.e. commercial justification) other than tax avoidance. The mere tax advantage cannot be an acceptable business purpose; it must show a business or non-tax purposes. Thus, it must have a valid business or economic purpose other than reduction of tax liability. If the primary purpose is something other than tax avoidance, the transaction represents acceptable tax planning. On the other hand, if the primary purpose is to obtain tax benefits and the transaction would not be carried out without those benefits, the transaction is treated as unacceptable tax avoidance.

(b) Substance over Form Rule:

Under the substance over form principle, the acts must be assessed according to bona fide economic and commercial substance and not the formal content. It requires establishment of the underlying economic reality. Under the substance over Form Principle there are 4 doctrines.

(i) **Lack of Economic Substance.**

It applies where due to the legal form used for the transaction a taxpayer has the real economic power over the taxable income without the tax liability.

(ii) **Sham Transactions:**

Sham transactions refer to transactions where the parties say one thing while intending another. In a Sham Transaction, they give effect to a transaction, which they do not carry out, or do not intend to carry out. The transactions are said to have happened that have not really happened, or are a cover up for another transaction. In short, they do not crate the legal rights and obligations, which they give the appearance of creating, since the relationships that are alleged to exist do not exist. A sham transaction hides the economic reality of a transaction that exists only in form.

For example, an entity may be legally set up as a partnership but it is not intended to operate as a partnership. Similarly, an employee may be deemed as an independent contractor. In a sale and lease back transaction; the transfer of the related rights and obligations of ownership may not accompany the sale of assets. Where the court holds that a transaction is a sham, they normally apply the tax rules based on the true economic position. The form of the transaction is disregarded when compared with the underlying substance.

(iii) **Doctrine of Label**

The parties use an incorrect “label” or description to classify the nature of the actual rights and liabilities in a transaction. Unlike a sham, the transactions do create rights and liabilities which do exist or which are not different from those that actually do exist. They are not artificial or fraudulent. For example, a loan may have a non-arm’s length rate of interest and no repayment terms. The label may describe the transaction as a loan when it should be treated as equity. In Ridge Securities vs IRC 44 TC 373, the court rejected a loan with interest at over 400% per annum as a loan transaction. In Council of India vs. Scobie 4TC 618, the court rejected a purchase consideration described as an annuity payable over a period of 47 years. The doctrine has also been involved to decide the price allocations in composite transaction**.** In Vestey vs. ITC [1949] 40 TC 112, the taxpayer had agreed to sell his shares at a consideration payable over 125 yearly installment, and treated the entire price as a capital receipt. The court held that a proportion should be treated as an interest payment. The label that the parties chose to attach to their payments was not conclusive of their character for tax purposes.

(iv) **The Step Transaction Doctrine:**
A step-transaction-doctrine has evolved which regards a series of connected transactions as a single transaction under the 'substance-over-form" principle. In a step transaction, the intermediate steps in a chain of pre-ordained, even if bona fide, transactions may be disregarded and several related transactions treated as a single composition transaction. Alternatively the transaction may be broken into its distinct steps to determine their acceptance for tax purposes. The step transaction doctrine maintains that "purely formal distinctions cannot obscure the substance of a transaction."

Self-Examination Questions

Question 1
Which is legal and permitted: tax avoidance or tax evasion?

Question 2
What are the strategies used by taxpayers to evade tax? (5 marks)

Question 3
What are the reasons cited as excuses for tax evasion? (7 marks)

Question 4
(a) Distinguish between 'tax evasion' and 'tax avoidance'.
(b) Enumerate at least five ways through which tax evasion and tax avoidance are committed.
(c) Summarise at least six consequences of tax evasion.

Question 5
The problem of tax avoidance and evasion is inherent in all tax systems. In fact, tax avoidance and evasion are as old as the taxes themselves and the Tanzanian taxation system is not exception to the fact.
Required:
(a) Briefly discuss the effects of tax evasion and avoidance in Tanzania
(b) With examples, discuss international and national perspective of tax evasion and avoidance.
(c) Briefly discuss measures taken by the government of the United Republic of Tanzania to deal with the problem of tax evasion and avoidance.

Answers to Self-Examination Questions

Answer to SEQ 1
Tax avoidance is legal and permitted whereas tax evasion is illegal.
Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting (such as under declaring income, profits or gains; or overstating deductions).
Tax avoidance is the legal exploitation of the tax region to one's own advantage to attempt to reduce the tax payable using means that are within the law while making a full disclosure of the material information to the tax authorities.

Answer to SEQ 2
i] Tax payers may avoid tax by making a false return of income by omitting income or overstating expenses.
ii] Tax payers also evade tax by preparation or maintenance of false books of accounts or records. This may involve manipulation of stock sheets and valuations, destruction of or defacing of accounting records, non-issue of sales receipts etc.

iii] The importers purport to evade customs duty by (a) under-invoicing and (b) mis-declaration of quantity and product-description. When there is ad valorem import duty, the tax base is reduced through under-invoicing. Mis-declaration of quantity is more relevant for products with specific duty.

iv] Smuggling is importation or exportation of foreign products through unauthorized route. Smuggling is resorted to for total evasion of leviable customs duties as well as for importation of contraband items.

v] Traders who collect VAT from the consumers may evade tax by under-reporting the amount of turnover.

Answer to SEQ 3

i] Low quality of the service in return for taxes
In general, citizens expect some kind of service or benefit in return for the taxes paid.
If the government fails to provide basic public goods and services or provides them insufficiently, citizens may not be willing to pay taxes and tax evasion and avoidance will be the consequence

ii] Tax rates
Some studies suggest that high tax rates foster evasion. The intuition is that high tax rates increase the tax burden and, hence, lower the disposable income of the taxpayer.

iii] Perceived tax system fairness
The structure of the overall tax system has an impact on taxpayers' willingness to pay tax. If, for example, the tax rate on corporate profits is relatively low, but individuals are facing a high tax rate on their personal income, they may perceive their personal tax burden as unfair and choose to declare only a part of their income. Similarly, large companies can often more easily take advantage of tax loopholes, thereby contributing to the perceived unfairness of the system.

iv] Low transparency and accountability of public institutions
Lack of transparency and accountability in the use of public funds contributes to public distrust both with respect to the tax system as well as the government. This, in turn, increases the willingness to evade taxes.

v] High level of Corruption
Corrupt tax officials influence both the willingness of the taxpayers to evasion and the role of tax administration in fighting evasion. A tax-payer might consider evading taxes if the cost of bribing a tax auditor is lower than the potential benefit from tax evasion.

vi] Lack of rule of law and weak fiscal jurisdiction
Strong fiscal courts are essential to protect taxpayer's rights and safeguard them from arbitrariness. If the legal system does not operate in accordance with the rule of law, citizens have to fear arbitrariness, discrimination, unequal attendance in court, etc. The lack of rule of law reduces transparency of public action and fosters distrust among citizens. As a result, citizens may not be willing to finance the state through taxes, and decide to evade these liabilities.

vii] Incapacity in detecting and prosecuting inappropriate tax practices
A well-functioning body of tax investigation is essential for the detection and prosecution of cases of tax fraud. The lack of sufficient capacities in tax administrations reduce the probability of detection that again influences the decision of a taxpayer as to whether evade or not. Additionally, the legal frame-work is an important prerequisite for any enforcement activity. For example, the size and nature of penalties that are incurred after evasion has been detected is directly connected to the level of tax compliance

Answer to SEQ 4

(a) Tax Avoidance

Is the practice and technique whereby one so arrange his business affairs such that he pays little or no tax at all but without contravention of tax laws. Tax avoidance takes advantage of any loophole and weaknesses, deficiencies and loose or vague clause in tax legislation to minimize tax liability. Therefore it is sometimes considered as legally allowed.

Tax evasion

Tax evasion on the other hand involves a tax payer's deliberate contravention of the tax laws in order to eliminate or minimize tax liability. It is the application of fraudlent practices in order to minimize or eliminate tax liability. For example:

- Making a false return of income
- Making a false statement in a return affecting tax liability
- Preparation and maintenance of false books of account or records

Tax evasion constitutes fraud which is heavily punishable by law.

(b) **There are several ways of committing tax fraud that include**

1. *Keeping two sets of books to record business transactions.* One records the actual business transactions while the other is **falsified** intentionally understating the taxable amount which is shown to the tax authorities. Some evaders use two cash registers.

2. *Moonlight for cash*. Working an extra job is perfectly legal. However, the income received on such jobs is often paid in cash rather than by cheque. Hence, no legal record exists, and the income is not reported to the tax authorities.
3. *Barter*. When you receive payment in kind instead of money, it is legally a taxable transaction. However, such income is seldom reported.

4. *Deal in cash*. Paying for goods and services with cash and cheques made out to "cash" makes it very difficult for the tax authorities to trace transactions.

5. Under-invoicing of imports.

6. Under-reporting of income especially where income is earned and paid in cash to hide transactions or exchanged in a barter way – receiving payment in kind instead of money.

7. Smuggling. Refers to business transactions which are done illegally and therefore not subjected to the requirements of paying taxes.

8. Money Laundering. Deals with dirty money which is normally covertly cleansed through legal business transactions.

9. Loopholes and weaknesses in the Law

10. Tax planning /Tax Arrangements

11. Transfer pricing

12. Changing Form of business eg from Sole Trader to Limited Company

13. Capitalization – Debt to Equity Ratio.

(c) **Consequences of Tax Evasion**

1. Less Government revenue: for provision of public goods, deficits and its consequences.
   - Non realization of other non-revenue goals of taxation e.g. inequality.

2. Heavy burden on those who comply leading to unequal income distribution.

3. Unfair competition.

   - Bring inequality in the tar system

4. More cost to tax authority.

   - Fine and Penalties and imprisonment.

5. Renders redistribution plan ineffective.

   - Punishment to tax payer.

6. Understating taxable capacities for countries.

   - Cost of goodwill/reputation of business.

7. Promote inefficiency allocation of resources.

   - Non Realization of government objective and plan

   - Non Realization of cannon of principles of tax

Answer to SEQ 5

(a) Effect of Tax Avoidance and Evasion

Tax avoidance is a practice and technique used by tax payers to minimize the taxpayer's tax burden without going against the tax laws. Tax avoidance takes place within the legal context of the tax system that individuals or firms take advantage of the tax code and exploit "loopholes", i.e. engage in activities that are legal but run counter to the purpose of the tax law. Usually, tax avoidance encompasses special activities with the sole purpose to reduce tax liabilities. An example for tax avoidance is strategic tax planning where financial affairs are arranged such in order to minimize tax liabilities by e.g. using tax deductions and taking advantage of tax credits.

In contrast evasion on the other hand is a practice and technique used by tax payers to minimize tax liability by contravening tax laws. In general tax evasion refers to illegal practices to escape from taxation. To this end, taxable income, profits liable to tax or other taxable activities are concealed, the amount and/or the source of income are misrepresented, or tax reducing factors such as deductions, exemptions or credits are deliberately overstated.

Both tax evasion and avoidance aim at reducing the taxpayer's tax burden. As tax can be used to achieve a number of objectives, a high degree of tax avoidance and evasion may hinder the achievement of taxation objectives, both revenue and non revenue objectives. This included

- Serious government revenue short falls which may bring about budget deficits that may ultimately lead into foreign loans grants dependency causing heavy foreign debt burden plus unfavorable conditions attached to grants.

- Non realization of other government economic and social development
- Creates inequality in the tax system as some law abiding citizens or those with no opportunities to evade or avoid tax bear disproportionally heavier tax burden than others.

(b) **International and national perspective of tax evasion and avoidance**

The international dimension of tax evasion and avoidance can be divided into two stylized strands:

On the one side, one can find – legal or natural – persons taking advantage of differences in tax laws or rates and the resulting tax liabilities between countries resulting in attempts to shift tax liabilities to low-tax countries. This starts with efforts to reduce tax payments in a private environment, e.g. tax-induced cross-border shopping and tank-tourism, and ends with the flight of financial capital to low tax destinations or tax havens.

On the other side, the international dimension of tax evasion and avoidance covers all kinds of tax evasion and avoidance activities which occur as a result of international trade, the international division of labour, and international competition for foreign investment. In this field, one can find multinational enterprises' (MNE) tax driven shifting of profits, tax evasion and avoidance against the background of investment incentives and special enterprise zones, as well as various kinds of VAT and tariff fraud accompanying international trade in goods and services.

Besides the international perspective there also exists a national dimension. This relates to all incidents in which individuals or firms evade or mitigate taxes within their country of residence while no transactions with companies or individuals abroad are involved. The national perspective comprises incomes and revenues generated in the domestic informal economy, income not reported by a legal or natural person and other means of 'getting around' solely domestic tax liabilities.

(c) Measures taken by the government of Tanzania to solve tax avoidance and evasion problem: Due to the negative effects of tax evasion and avoidance, it is the interest of the government to keep the level of tax avoidance and evasion to the minimum level possible. This has been reflected, among others, through the following ways;

- Imposition of disciplinary measures against those evading taxes

- Timely amendments of the tax acts whenever it is detected that certain provisions of the law allows tax avoidance in the major scale. For example in the fiscal year 2012/2013 the definition of Income Tax was amended to include a person with unrelieved loss to pay tax on their turnover. Definition of the term "exempt amount" has been amended by deleting the figure "54" appearing in the definition. This is a consequential amendment emanating from the amendment of Section 54 (2).

- Major tax reforms, for example the VAT Act 1997 has been replaced by VAT Act 2014 to address weaknesses and loopholes in the previous law.
- The introduction of electronic fiscal devices
- Promotion of voluntary tax compliance to tax payers through education.
- Anti-avoidance provision

SECTION C

INCOME TAX

C1

STUDY GUIDE C1: INTRODUCTION TO INCOME TAXATION

Get Through Intro

This Study Guide introduces to the concept of income taxation. The focus of this Study Guide is primarily the Income Tax Act, Cap 332

Learning Outcomes

a) Explain the concept of income for income taxation
b) Explain the legal sources of income tax laws
c) Explain the basis of income taxation(Chargeable income and total income)
d) Determine the residential status of an individual, a partnership, trust and corporation
e) Describe the source of income and loss rules for income taxation
f) Explain relevant matters underlying income taxation (year of income and basis of accounting)
g) Explain Quantification, Characterization & Allocation rules and the Income Tax Act, Cap 332

Explain the concept of income for income taxation; explain the legal sources of income tax laws and explain the basis of income taxation (Chargeable income and total income).

[Learning outcome a, b,

1. The Concept Of Income For Income Taxation

The following terms are very important for income taxation. They will be referred to from time to time in the rest of this book.

1.1 Income

In an effort to define the term "income tax", we need to ascertain the exact meaning of the term "income". Indeed, whether income is an accurate measure of tax paying ability depends on how income is defined.

However it has been difficult to give a concise and all-embracing definition of income, and any attempt to define the term merely creates considerable problems of semantics and hence litigation and possibly confusion.

The Act has considered it expedient not to define income but rather to enumerate all the possible sources of income that are liable to income taxation.

Definition

Income is defined to mean a person's income from any employment, business or investment and an aggregation of such income as calculated in accordance with the Income Tax Act

As it can be seen the above definition does not really define income but describes it in terms of its various sources. This leaves the term income not defined in the Income Tax Act, however, several definitions have been offered as described below:

Definition

The Hicksian concept of income defines income as the maximum value which a man can consume during the period and still expect to be as well off at the end of the period as he was at the beginning. The term “to be well off [equity] as at the beginning” refers to capital maintenance which calls for inflation adjustment of the earlier figure. ‘Hicksian income’ is the standard concept of income as traditionally used by accountants and also by the more thoughtful economists. Income, thus defined, must not contain any element of capital.

Hicks, (1939)

Another definition that has been found to be theoretically ideal and free from anomalies is the Haig-Simons definition of income, based on the work by American economists Robert M. Haig and Henry Simons.

The basic Haig–Simons definition of income is the value of what one could consume in that year, while keeping the wealth constant. It is the value of all consumption in a given year plus the change in net worth.

Notice that it’s not what a person does consume in a year which is the basis for Haig–Simons income; it’s what she could consume if she chose to keep the value of her wealth constant. So it is based on potential consumption, not actual consumption. The idea is that how well–off a person is should be measured by how much she could afford to consume each year. According to Haig and Simons the measure of one’s income should be not what one actually did with it (spend it or save it), but what one could do with it.

For many reasons, both practical and political, the actual definition of income in the income tax code falls considerably short of that definition. A full Haig-Simons concept of income, for example, would include the value of ALL consumption and ALL changes in net worth. As we have seen and will continue to see, in actual practice the definition of income used on the ITA is quite different.

Others define income as some benefit, monetary or otherwise, which an individual "enjoys" periodically. This definition is somehow incomprehensive since it is hard to define enjoyment.

Despite difficulty in defining the term income, economists refer to the Hicks definition to provide ways of measuring income, while accountants use realisation concept to measure income for a particular period.

(i) Equity or economic concept of income

The definition provided by Hick, (1939) requires calculation of capital at the beginning of the period and at the end of the period. From basic accounting knowledge the equity or capital is the difference between total assets and total liabilities. Hence, any incremental amount from the earlier capital amount is deemed to be income, strictly to attain what Hicks intended it must be after inflation adjustment of the earlier equity. Since taxation is paid on cash basis, any tax based on this definition might be perceived unfair as the associated income is not actually received.

(ii) Realisation or accounting concept of income

This concept is more popular and widely adopted by tax officials, and tax practitioners in income based tax system in the world. According to this concept, income arises only at the time of sale, disposal or exchange of a product or goods, which creates the income or gain. Therefore income is not realised earlier at the production stage during which period an asset is held while its values or prices rise (inflationary gains).

3. Classification of income

The following are classification of income:

(a) Cash income and benefit / income in kind

Cash income is income received or to be received in monetary terms e.g. salary, interest, dividend etc. Income in kind on the other hand is the income received in non-monetary terms such as free house, car, air time and a driver. Income in kind may further be categorised into convertible and non convertible income.

i] Convertible income is where the benefit may be converted into money or money's worth.

ii] Non-convertible income in kind is where the benefit cannot be converted into money or money's worth.

Example

i] Convertible income

A bonus of 100 bags of cement may be converted into cash by selling in cash or may be exchanged for another product say floor tiles

ii] Non-convertible income

Free lunch or free use of employer's motor vehicle

(b) Exempt income or income exempt

Exempt income is income not taxed because the source is exempt. The income does not form part of the total income to be included in the income tax return. A good example is occupying own premises, and utilizing own agricultural produce.

(b) Exempt income or income exempt

Exempt income is income not taxed because the source is exempt. The income does not form part of the total income to be included in the income tax return. A good example is occupying own premises, and utilizing own agricultural produce.

Income exempt is income accrued or derived from a source that forms part of the tax base, but because of some specific/particular circumstances by the operation of any regulation, law, order or rule, such income is exempt from income tax; for example, minimum threshold for employment income, the salary of the president of the URT, scholarship income etc.

However both, exempt income and income exempt are not taxable.

Income exemption

The following income has been exempt from income tax under the Income Tax Act ,Cap 332:

- Presidential income both of Tanzania and Zanzibar;
- Income earned by government or its agencies in performing government activities;
- Amounts derived by any person entitled to privileges under the Diplomatic and Consular Immunities and Privileges Act to the extent provided in that Act or in regulations made under that Act;
- Income earned by public servants in a foreign country paid by the government;
- Foreign source income earned by non resident person or income of a spouse or child of a public servants working abroad where the spouse is resident in the United Republic solely by reason of accompanying the individual on the employment;
- Income earned by the East Africa Development Bank; the Price Stabilization and Agricultural Inputs Trust; the Investor Compensation Fund under the Capital Markets Regulatory Authority; and The Bank of Tanzania;
- Amounts derived during a year of income by a primary co-operative society Registered under the Cooperative Societies Act; solely engaged in activities as a primary co-operative engaged in either: agricultural activities, including activities related to marketing and distribution; construction of houses for members of the cooperative; distribution trade for the benefit of the members of the cooperative; savings and credit society; and whose turnover for the year of income does not exceedTshs50,000,000;
- Pensions or gratuities granted in respect of wounds or disabilities caused in war and suffered by the recipients of such pensions or gratuities;
- A scholarship or education grant payable in respect of tuition or fees for full-time instruction at an educational institution;
- Amounts derived by way of alimony, maintenance or child support under a judicial order or written agreement;
- Amounts derived by way of gift, bequest or inheritance, except amount earned by the estate of the deceased from business and investment or employment of the deceased;
- Amounts derived in respect of an asset that is not a business asset, depreciable asset, investment asset or trading stock;
- Amounts derived by way of foreign living allowance by any officer of the government that are paid from public funds and in respect of performance of the office overseas;
- Income derived from investments exempted under the Export Processing Zones Act;
- Amount derived from investments exempted under any written laws for the time being in force in Tanzania Zanzibar;
- Rental charges on aircraft lease paid to a non-resident by a person engaged in air transport business;
- Amounts derived by a crop fund established by farmers under a registered farmers' cooperative society, union or association for financing crop procurement from its members;
- Income earned by Dar es salaam Stock Exchange [DSE];
- Income earned by holders of gaming licenses;
- And the fidelity fund established under the Capital Markets and Securities Act.

(c) Earned income and unearned income

Earned income is realised income e.g. salary and business profit while unearned income includes capital gain not realised from sales but simply an increase in value of assets. Income is earned when you have done something substantial to be entitled to receive it as provision of services, goods or passage of time.

2. The Legal Sources Of Income Tax Laws

A person shall not be charged tax unless there is a clear legal provision requiring the person to be charged such tax. In other words, a tax charge must be established by law.

The sources of income tax laws are the following:

(i) Statutes

A statute is a formal written enactment (act) of a parliament of a particular state governing various taxation for that state. It is a primary authority on matters of income tax, yet must be constitutional. In Tanzania, tax statutes are made up of both the principal legislations and the subsequent Finance Acts which amends the principal legislation from time to time. Usually the Finance Acts are passed during the annual parliamentary budget sessions.

(ii) Regulations

The principal legislation allows the Minister responsible with tax administration [in this case, the Minister of Finance] to prepare regulations where necessary as additional provisions with respect to tax laws for the better implementation of the principles, purposes and provisions of the principal Acts. The regulations usually carry the same authority as that of the principal act.

(iii) Practice Notes

The Commissioner responsible with tax administration is allowed by the respective principal Acts to prepare practice notes to achieve consistency in the administration of the principal act and to provide guidance to persons affected by it. The practice notes usually carry the same authority as that of the principal act.

(iv) Case Laws

These are sets of rules of law which have been established based on previous court cases. Basically, previous courts' decisions set precedence that may be used to judge subsequent similar cases. Where a legal case is decided today (by the High Court or Court of Appeal), it becomes an authority over which similar subsequent cases, presided in any other court of law or tribunal in that particular jurisdiction, may be decided on the authority of such previous case.

3. Basis Of Income Taxation (Chargeable Income and Total Income)

3.1 Imposition of Income Tax

S.4 of Income Tax Act Cap 332 states that **income tax** shall be **charged and is payable** for each **year of income** by every **person**-

i] Who has total income for the year of income or is a corporation which has a perpetual unrelieved loss determined under section 19 for the year of income and the previous two consecutive years of income.

ii] Who has a domestic permanent establishment that has repatriated income for the year of income; or

iii] Who receives a final withholding payment during the year of income

3.2 Chargeable income

Section 6 (1) of the Income Tax Act, Cap 332 provides that the scope of charge of income tax:

(a) in the case of a resident person, shall be the person's income irrespective of the source (worldwide); and

(b) In the case of a non-resident person, the person's income that has a source in the United Republic.

The application of the provisions is to tax in Tanzania the worldwide income of a resident person and tax a non-resident person only the person's income that has a source in the United Republic. The Act provides the criteria for distinguishing various income sources that has a source in United Republic as against foreign-sourced income.

Section 6(2) provides that the chargeable income of a resident individual who at the end of the year of income has been resident in the United Republic for a period of two years or less in total during the whole of the individual's life shall be only the individual's income that has a source in the United Republic.

3.3 Total income

Total income of a person for a year of income is the sum of the person's chargeable income for the year of income from each employment, business and investment less any reduction allowed under section 61 relating to retirement contributions to approved retirement funds. The total income of each person shall be determined separately. Income tax is charged on a person's total income for a year of income. A person's total income for a year of income shall be calculated by aggregating the income, from each employment, business and investment separately calculated in accordance with the rules provides for under the Act in respect of each of the income sources.

Definitions

"**Person"** means an individual or an entity;

"Individual" means a natural person;

"Entity" means a partnership, trust or corporation

A "**corporation"** means any company or body corporate established, incorporated or registered under any law in force in the United Republic or elsewhere, an unincorporated association or other body of persons, a government, a political subdivision of a government, a parastatalorganisation, a public international organisation and a unit trust but *excludes* a partnership

"Partnership" means any association of individuals or bodies corporate carrying on business jointly, irrespective of whether the association is recorded in writing;

Determine the residential status of an individual, a partnership, trust and corporation; describe the source of income and loss rules for income taxation; explain relevant matters underlying income taxation and explain Quantification, Characterization & Allocation rules and the Income Tax Act, Cap 332 [Learning outcome d, e, f and g]

4. The Residential Status Of An Individual, A Partnership, Trust And Corporation

4.1 Tax residence

Residence has not been defined in the Income Tax Act 2004; it provides criteria for a person to qualify to be a resident for a particular period for individual, partnership, trust and corporation.

(i) Test of residence of an individual

An individual is resident in the United Republic for a year of income in the following cases:

a) when she/he has a permanent home in the United Republic and is present in the United Republic during any part of the year of income;
b) if she/he has no permanent home, is present in Tanzania during the year of income for a period amounting in aggregate to 183 days or more (in accordance with a case law this excludes arrival and departure day);
c) if the aggregate days in the year of income is less than 183, but he/she is present in the United Republic during the year of income and in each of the two preceding years of income for periods averaging more than 122 days in each such year of income; simple average (Y1 +Y2+Y3)/3 is used; or
d) is an employee or an official of the Government of Tanzania posted abroad during the year of income.

Therefore, a Tanzanian citizen may or may not be resident in Tanzania for tax purposes. However, an individual who at the end of the year of income has been resident in Tanzania for two years or less in total during the whole of the individual's life for purpose of calculation of chargeable income is considered nonresident.

Permanent home is any place any individual is free and not restricted to reside, not necessary his/her own house may be a hotel, rented house etc

Example

Mr. Limbu has a permanent home in Tanzania but was abroad for several years and is still living abroad.

Required:

Determine the residential status of the taxpayer.

Answer

Though he has a permanent home in Tanzania and is a Tanzanian citizen, he will not be considered nonresident because he is staying abroad.

Example

In 2010, Mr. Sadiki, who has no permanent home in Tanzania came to Tanzania for holiday and stayed for 200 days.

Required:

Determine the residential status of Mr. Sadiki for the year of income 2010.

Answer

Since his stay in Tanzania during the year 2010 was of over 183 days, he will be regarded resident in Tanzania during the year of income. However, since he has been resident in Tanzania for two years or less in total during the whole of his life for purpose of calculation of chargeable income, he is considered non- resident.

Example

Mr. Bure has no permanent home in Tanzania. He has been frequently visiting the country for business purposes. In 2013 he stayed for 120 days, and in 2012 and 2011 he stayed in Tanzania for 140 and 100 days respectively.

Required:

Determine the residential status of Mr. Bure.

Answer

Since Mr. Bure was present in Tanzania for an average of less than 122 days for the year of income and the two preceding years i.e. years 2013,2012 and 2011, average (120+140+100)/3=120 days he is treated as nonresident for the year 2013.

Example

MrsKessy is employed by a Tanzania private entity and has been seconded in Rwanda since 2007. Mrs. Kessydid not come to Tanzania during the year of income 2010.

Required:

Determine the residential status of MrsKessy for the year of income 2010.

Answer

Since MrsKessy is not a government official, regardless of her citizenship she is considered a non-resident in Tanzania during the year of income 2010.

(ii) Test of residence of a partnership

A partnership is a resident partnership for a year of income if at any time during the year of income a partner is a resident of the United Republic.

(iii) Tests of residence of a trust

A trust is a resident trust for a year of income if:

a) it was established in the United Republic and
b) at any time during the year of income, a trustee of the trust is a resident person; or
c) at any time during the year of income a resident person directs or may direct senior managerial decisions of the trust, whether the direction is or may be made alone or jointly with other persons or directly or through one or more interposed entities.

Example

Assume that Mayfair Trust is a registered trust in Tanzania. In 2011 all of Mayfair trustees were non-residents, however the CEO of the trust is a resident individual.

Required:

Determine the residential status of the trust for the year of income 2011.

Answer

Since the trust was established in Tanzania, by registration under a Tanzania law, and directed by resident person CEO, the trust is resident for 2011.

Example

Assume that Mayfair Trust was not registered trust in Tanzania but it operates in Tanzania. In 2010 all the trustees, including the CEO were resident individuals.

Required:

Determine the residential status of the trust.

Answer

Since the trust was not registered in Tanzania the trust is treated as non-resident for the year 2010 though all its trustees were resident in Tanzania during the year.

(iv) Tests of residence of a corporation

A corporation is a resident corporation for a year of income if:

a) it is incorporated or formed under the laws of the United Republic; or
b) at any time during the year of income the management and control of the affairs of the corporation are exercised in the United Republic. The control of a company is exercised at the meeting of directors.

Significances of classifying a person as resident in the United Republic of Tanzania for income taxes purposes

(i) Scope of income chargeability differ

By virtual of section 6(1) chargeable income of a person for the year of income from employment, business or investment is:

(a) In the case of resident person, the persons income from employment, business, or investment for the year of income irrespective of the source of income; and
(b) In case of non-resident person, the persons income from employment, business or investment for the year of income, but only to the extent that the income has a source in the United Republic.

(ii) Individual tax rates on total income differ

(a) Under paragraph 1(1) of the 1st schedule, total income of a resident individual (except presumptive tax payers) only is taxed using progressive tax rates provided.

(b) The total income of a non-resident individual for a year of income is taxed at the rate of 20 percent.

(iii) Withholding tax rates differ.

Under the 1st schedule paragraph 4, withholding tax rates differ, for example

Payment		Rate for Resident	Rate for Non Resident
(i)	Employment	Regulation	15%
(i)	Rental Income	10%	15%
(ii)	Technical services fees (mining)	5%	15%
(iii)	Insurance Premium	0%	5%
(iv)	Service Fees	5%	15%

(iv) Capital gain tax rates in realisation of interest in land or building and shares differ

An individual instalment payer who derives capital gains shall pay income tax equal to

(a) in the case of a resident individual, ten percent of the gain, or

(b) in the case of a non-resident individual, twenty percent of the gain.

(v) Foreign Tax relief

Under section 77 ,a resident person (other than a partnership) may claim a foreign tax credit for a year of income for any foreign income tax paid by the person to the extent to which it is paid with respect to the person's taxable foreign income for the year of income.

Such relief cannot be granted to a non resident person

5. Source Of Income And Loss Rules For Income Taxation

For the purposes of income taxation, a person shall calculate the person's income or loss from employment, business or investment that has a source in the United Republic separately from any income or loss from employment, business or investment that has a foreign source.

Income or loss which has source in the United Republic of Tanzania

(i) Income of a person from employment, business or investment has a source in the United Republic if the amounts directly included in calculating that income that have a source in the United Republic exceed the amounts directly deducted in calculating that income that have a source in the United Republic.

(ii) Loss of a person from any business or investment has a source in the United Republic to the extent that the amounts directly deducted in calculating the income from business or investment exceed the amounts directly included in calculating that income.

Income or loss which has a foreign source

A person's foreign source of income from an employment or of income or loss from, business or investment shall be calculated as follows –

i) the person's worldwide income or loss from that employment or business or investment; less

ii) any income with a source in the United Republic from that employment, business or investment; or plus

iii) any loss with a source in the United Republic from that business or investment.

Sources of inclusions and deductions

Inclusions with the source in URT

Amounts directly included in calculating income have a source in the United Republic where they consist of –

(a)

- i) Incomings for trading stocks (sales revenue in URT)
- ii) Gains from realization of business assets or liabilities of the where the asset or liability involved is a domestic asset or domestic liability.
- iii) Gains on realization depreciable assets on pool basis, if disposed depreciable asset is in URT

(b) In other cases, the income has a source in URT if the *source of payment* is in URT.

Deductions with source in URT

Amounts directly deducted in calculating income have a source in the United Republic where they consist of –

(a)

- (i) Trading stock allowances calculated in accordance with section 13(2) of the Act.
- (ii) Depreciation allowance in respect of depreciable assets owned and employed by a person wholly and exclusively in the production of the person's income from the business.
- (iii) Expenditure in respect of repair and maintenance of depreciable assets owned and employed by a person wholly and exclusively in the production of income from business to the extent to which
  - i) they relate to domestic assets; or
  - ii) they relates to moveable tangible assets used by a person who conducts a business of land, sea or air transport operator or charterer to carry passengers who embark or cargo or mail which is embarked from Tanzania.

(b) Losses from the realisation of business assets, investment assets and liabilities of a business where the asset or liability involved is a domestic asset or domestic liability.

(c) In other cases, the deduction has a source in URT if the *source of payment* is in URT.

Sources of payments

The following payments have a source in the United Republic Tanzania

(a) dividends paid by a resident corporation;

(b) interest paid by a resident person or domestic permanent establishment;

(c) natural resource payments made in respect of or calculated by reference to natural resources taken from land or the sea situated within the United Republic or its territorial waters;

(d) rent paid for the use of, right to use or forbearance from using an asset situated in the United Republic;

(e) royalties paid for the use of, right to use or forbearance from using an asset in the United Republic;

(f) premiums for general insurance paid to and proceeds from general insurance paid by a person in respect of the insurance of any risk in the United Republic;

(g) payments received by a person who conducts a business of land, sea or air transport operator or charterer in respect of

- i) the carriage of passengers who embark or cargo, mail or other moveable tangible assets that are embarked in the United Republic, other than as a result of transshipment; or
- ii) rental of containers and related equipment which are supplementary or incidental to carriage referred to in subparagraph (i);

(h) payments received by a person who conducts a business of transmitting messages by cable, radio, optical fibre or satellite or electronic communication in respect of the transmission of messages by apparatus established in the United Republic, whether or not such messages originate in the United Republic;

(i) payments, including service fees, of a type not mentioned in paragraphs (g) or (h) for or attributable to employment exercised, service rendered or a forbearance from exercising employment or rendering service :-
  - i) in the United Republic, regardless of the place of payment; or
  - ii) whether the payer is the Government of the United Republic, irrespective of the place of exercise, rendering or forbearance;

(j) proceeds of life insurance and retirement payments not falling within paragraph (i) paid by a resident person or a domestic permanent establishment and any premium or retirement contribution paid to a resident person or domestic permanent establishment to secure such a return;

(k) gifts and other ex-gratia payments to the extent received in respect of business or investment conducted with domestic assets; and

(l) payments not mentioned in the above paragraphs made in respect of:-
  - i) the acquisition of a domestic asset, incurring of a domestic liability or realization of such an asset or liability; or
  - ii) Activity conducted or forbearance from conducting activity in the United Republic.

6. Relevant Matters Underlying Income Taxation

6.1 Year of income

Section 20(1) of the Act provides that income tax shall be charged and is payable for each year or income that is annual basis. It is therefore necessary to specify the year of income. The year of income is specified under the subsection as the calendar year that is the 12 months period commencing on 1st January in any year and ending on 31st December in each year. However, the Act permits an entity to substitute a different 12-months period as the entity's' year of income. Allowing persons to close a year of income at different times may result to some revenue loss if the persons are able to exploit the inconsistency. The Act therefore demands that a person should be allowed to use a substitute year of income only with the permission of the Commissioner.

6.2 Application for approval to change the year of income

Section 20(2) provides that where an entity shows that there is a compelling need requiring changing from one accounting date to another, hence the change in the entity's year of income the entity may apply in writing to the Commissioner for approval to change from the calendar year or the previous approved year. The Commissioner will communicate to the entity the determination of the entity's application in writing.

6.3 Conditions of approval

Section 20(3) demands the entity applying for change in the entity's year of income to show compelling need to change the year of income. The Commissioner will approve the change only where is satisfied that the whole or a portion f the entity's income cannot be correctly reported fro any year of income under the current accounting cycle or there is substantial business need to make the change. The Commissioner will not approve an application for change where is of the view that the purpose or one of the purposes of the change is to avoid or reduce tax. For example a change may be requested that may put the person in a position to benefit from reduced tax rate or change in certain tax policy decisions.

6.4 Notice of approval of change

Section 20(3) demands that where the Commissioner has approved a change of a year of income shall communicate the approval to the applicant by notice in writing.

6.5 Revocation of the Commissioner's approval

Section 20(4) empowers the Commissioner to revoke an approval granted to an entity to change the entity's year of income. The revocation shall be by a notice in writing addressed to the entity. Although the Act does not require the Commissioner to give reasons for the revocation it is best practice and just to give reasons for an revocation of the approval previously granted.

6.6 Transitional year of income

Section 20(5) stipulates that where an entity's year of income changes, such change should not exceed the period of 18 months. That is, the year of income should be of the length of up to 12 months or 18 month's. In case the transitional accounting period is less than 12 months, the income should be treated as income of the year in which the accounting period ends. If the new accounting period is of more than 12 month, and ends in the year following that in which a 12 months accounting period would have ended, the income is to be apportioned over the period, viz. for the 12 months to the old accounting date and the balance to the new period, and profit assessed as if the accounts had been made up for 12 months to the old date and for the shorter period to the new. For example, if the usual accounting date has been 30th September, 2016 and accounts for 18 months period are made up to 31st March 2017, two-thirds of the income of the accounting period is to be assessed for the year of income 2017 and one-third for the year of income 2017. Where a new accounting period ends in the same year as that in which a 12 months' period would have ended, the income for the whole of the accounting period is to be assessed for that year of income.

6.7 Year of income of a foreign permanent establishment

Section 20(6) provides that the year of income for every person's foreign permanent establishment shall be the same as the year of income of its owner. For example, where a resident company with foreign permanent establishment makes accounts on 31st December, then, the accounting date of that foreign permanent establishment shall be 31st December so as to coincide with the accounting date of that resident company (the owner).

6.8 Year of income of a non-resident entity

Section 20(7) provides that the year of income for every non-resident partnership, trust of corporation shall not exceed the period of twelve months for which the entity makes up its accounting if it is not the calendar year. Otherwise the year of income shall be the calendar year.

6.9 Initial year of income

Under the provisions of subsection 20(8) the initial year of income of a person shall be the period of twelve months or less. However, the Commissioner may approve a period of not exceeding eighteen month. Where the first accountings of a new business are for a period of 12 months ending on a date other than 31t December, that is where two calendar years are covered, the profits are, nevertheless, to be treated as income for the year of income in which the accounting period ends. Where the first accounts are for the period of less than 12 months, the profits are to be treated as income of the business for the year of income in which the accounting period ends. Where they are for a period greater than twelve months, a twelve months' proportion of the profits shall be treated as income of the year of income in which the accounting period ended, and the balance of the profit as that of the year of income in which the initial broken period ended.

Example

A new business prepares its first accounts for a period of 15 months ended on 31st January 2017, that is, for a period of November 2015 to 31st January 2017. The business made a profit of TZS. 900,000,000 over the period.

Apportionment of income

(i) The proportion of profits for 12 months shall be treated as income for year of income in which the accounting period ends, i.e. year 2017.

(ii) The portion of profits for 3 months (the balance) shall be treated as income for the year of income in which the initial broken period ended, (i.e. year 2016).

The apportionment shall be as follows:

Year 2016 (3 moths) - TZS. 120,000,000

Year 2017 (12 months - TZS. 720,000,000

The profits will be assessed in the respective year of income apportioned.

6.10 **Cessation**

In the case of cessation, and final accounting period ends within the final year of income, or where final accounting period exceeds 12 months, then the profit are to be assessed for the year on the basis of twelve months proportion. Otherwise, if the final accounting period is for less that 12 months and end in the year of income following the preceding accounting period ended, the profits are to be treated as the income of the final year in the same way as the profits of the initial accounting period a new business is treated as the income of the first year. Where the final accounting period is for 12 months, the income is to be treated as that of the final year of income.

7. Basis for accounting for income tax purposes

The use of a year of income to measure, on annual basis, gains and profit from economic activities that extend over more than one year of income needs rules to allocate income and expenses to particular years of income. Every taxpayer reports income and expenses for tax purposes according to a method of accounting. An accounting method is a set of rules used to determine when and how to report income and expenses. Basically, accounting methods are divided into two categories-the cash and accrual methods. The methods of accounting to be used should be that which clearly shows a person's income. That is, an accounting method, which consistently provide same treatment of income and expenses from year to year.

7.1 Use of generally accepted accounting principles

Section 21(1) provides that, subject to the directions in this section a person shall account the persons' income according to generally accepted accounting principles.

7.2 Accounting by an individual

Section 21(2) provided that an individual shall account for tax purposes revenue and expenditure based on cash basis with respect to the entire individual's income from employment and investment.

For purposes of accounting for business income an individual may account on accrual basis or cash basis, whichever method reflects more clearly the individual's income from the business.

7.3 Accounting by entities

Section 21(3) provides that, entities shall account for income tax based on accrual methods of accounting. All persons other than individuals shall account their income for tax purposes on accrual basis.

7.4 Accounting by Partnerships and Trusts

Section 21(4) provides that in calculating income from a business, partnerships and trusts shall account for income tax purposes on either cash or accrual basis according to the method that most clearly reflects the person's gains or profits. Exception to this is where the Commissioner may prescribe in writing that the accounting be in either of the methods, that is where there is specific direction as to which method should be used.

7.5 Change in the person's basis of accounting

Section 21(5) provides that a person may change the basis of accounting for income tax purposes by applying in writing to the Commissioner to be allowed to make the change. Upon satisfaction, the Commissioner may by notice in writing approve the application. For the purposes of this case, the Commissioner has to be satisfied that the change is necessary and the method shall clearly reflect the person's gain and profits. The satisfaction by the Commissioner is essential in order to ensure that the accounting method being used does not omit or take into account any item more than once.

8. Quantification, Characterization & Allocation rules and the Income Tax Act, Cap 332

1. Quantification of benefits in kind (sec.27)

Generally the value of benefit in kind is quantified by the market value of benefit in kind is quantified by the market value of the benefit, which means, the amount of money that knowledgeable, willing persons in an arm's length transaction would pay to receive the same good or service. However, special quantification rules have been provided under section 27 of the Act to apply to the provision of motor vehicle, subsidized loans and provision of housing. (See, employment income topic)

2. **Quantification in shillings (sec.28)**
   All amounts used in calculating the taxpayer's income are required to be quantified in Tanzania shillings. The amount quantified in a different currency must be converted at the exchange rate quoted by the Bank of Tanzania and applying between the currency and the shilling at the time the amount is taken into account for income tax purposes.
   Where the Commissioner General permits, by notice in writing, a person may use the average exchange rate applying during the year of income as determined by the Commissioner General

3. **Compensation Received (Sec. 31)**
   Where a person or an associate of the person derives an amount ("the compensation amount") which compensates for or represents recovery of -
   (a) income or an amount to be included in calculating income, which the person expects or expected to derive; or
   (b) a loss or an amount to be deducted in calculating income, which the person has incurred or which the person expects or expected to incur, the compensation amount shall be included in calculating income

Re- Characterization and Allocation

1. **Indirect payments (Sec. 29)**
   In case a person attained any advantage of a payment made by a payer or his associate, or any person authorizes someone to receive the amount, Commissioner may, by written notice, treat the person who receives the advantage or authorizes another person to receive the amount, as it receives the amount.
2. **Jointly owned investment (Sec 30)**
   For the purposes of calculating a person's income from an investment that is jointly owned with another person, amounts to be included and deducted in that calculation shall be apportioned among the joint owners in proportion to their respective interests in the investment. Where the interests of joint owners cannot be ascertained they shall be treated as equal.
3. **Transfer Pricing and Other Arrangements between Associates (Sec. 33)**
   In any arrangement between associated persons, operated by them according to general market practices (at arm‟s length), Commissioner may, by a notification in writing, distribute, apportion, or allocate the amounts to be included or deducted in the income between the persons as to reflect their taxable income or tax liability. In this process, Commissioner can:
   a) Re-characterize the source and type of any income, loss, and amount of payment; or
   b) Allocate costs, including the head office expenses, incurred by one person in conducting a business that benefits an associate or associates also in conducting their businesses, based on the comparative turnover of the businesses.
4. **Income Splitting (Sec. 34)**
   Section 34(1), In case any person arrange to split income with another person to reduce tax liability, Commissioner upon notifying in writing,
   i. Adjust the amount to be included or deducted in calculating the income of each persons from splitting of the income.
   ii. Re-characterise the source and type of any income, loss, amount or payment, to prevent any reduction in tax payable as a result of the splitting of income.
5. **Annuities, installment sales and finance leases(Sec. 32)**
   Payments under an annuity, an installment sale, or a finance lease are re-characterized as interest and a repayment of capital under a debt claim *(s 32 (1))*. The idea behind this rule is that annuities, installment sales, and finance leases are economically equivalent. Therefore, it needs to be ensured that these substitutable forms of financing are treated similar.

   All payments under an annuity, an installment sale, or a finance lease must be aggregated. The total is then to be divided into a capital portion and an interest portion. The capital portion is treated as a repayment of capital and the interest portion is dealt with as interest paid or to be paid . Each of these portions is calculated as described in detail in *s 32 (2)*. At the time of concluding an annuity, installment sale, or finance lease the taxpayer, who receives the payment, is required to determine the installments and segregate the installments into an interest and a capital portion *(s 32 (3))*.

If the taxpayer cannot provide such a list he must treat the interest and capital portion of the annuity, installment sale, or finance lease as a blended loan with the interest compounded six monthly.

A **blended loan** means a loan under which payments by the borrower represent in part a payment of interest and a part a repayment of capital and

(1) The interest part is calculated on capital outstanding at the time of each payment, and
(2) The rate of interest is uniform over the term of the loan.

Self-Examination Questions

Question 1

	Selina	Chichi	Kristina
2010	184 days	188 days	242 days
2011	127 days	127 days	-
2012	4 days	91 days	127 days
2013	148 days	148 days	123 days

Required:

For each individual, explain whether she is resident/not resident in the years of income 2010, 2011 and 2013.

Question 2

Differentiate among the following terms:

a) To charge and assess;
b) Exempt income and income exempt;
c) A person and an individual;
d) Benefit in kind and in cash;
e) Entity and corporations.

Question 3

How do you determine the residential status of a Chinese company which has been operating in Tanzania since January 2011?

Question 4

An entity commences a business on 01.07.2012 and accounts are prepared as follows: 01.04.2013 to 31.03.2014, and subsequently to 31 March.

The adjusted income of the company's business is as follows:

Accounting period	**adjusted income**
01.07.2012 to 31.03.2013	Tshs.150m
01.04.2013 to 31.03.2014	Tshs.240m

Required
Calculate the amounts that will be chargeable to company income tax in respect of the trade for the tax years 2012, 2013 and 2014.

Question 5

Louise, a Danish national is a prominent baker who has a large bakery in Kigamboni – Dar es Salaam, baking and distributing tasty traditional Danish cakes. To avoid house chores so that she can concentrate on her recipes, she lives in a rented suite in one of the expensive beach hotels in Kigamboni. During the year of income 2015, she was invited to make a presentation on her business model at business summit in Stockholm – Sweden, where she was paid TZS.42,401,700 equivalent award by the organizers, who also covered her return travel fare. She had time during the Stockholm visit to greet her friend who lives in their house in Copenhagen – Denmark. In total, the trip took 18 days. She had other trip within East Africa during the year, with days spent on such trips, aggregating to 165 days. The amount she was paid in the summit was taxed in Sweden, but she wants to understand the taxability of the amount in Tanzania.

Required:

(i) State the conditions under which a person's income would be taxable in the United Republic of Tanzania.

(ii) State, with reason(s) whether Louise's income above would be taxable in Tanzania, clearly specify further information (if any) you would need to conclude on the same.

(iii) Would the taxing of the income in Sweden put Louise in a disadvantage? Under what circumstances?

Question 6

Study the following three given scenarios;

a. Mr. Judah maintains a permanent home in the United Republic of Tanzania (URT). He was outside Tanzania (abroad) between 01.01.2012 and 08.12.2013 and came back to Tanzania between 08.12.2013 and 25.12.2013.

b. Ms Cathie was outside the United Republic of Tanzania but returned to Tanzania on 11th June 2013 and again left Tanzania on 21st January 2014.

c. Mrs. Pakutokea is employed by the Tanzania Government and was posted at the Tanzania Embassy in Tokyo Japan since 1st August 2012. She did not come to Tanzania during the year of income 2013.

Required:

For each of the scenarios above, state and explain whether the person mentioned was a resident of United Republic of Tanzania for the year of income 2013.

Question 7

(a) Mr. Kamar is an Indian who came to Tanzania for the first time in 3rd June 2011 to work in an NGO known as HEKI (T) Ltd. On 28th February 2012, HEKI (T) Ltd sent him to Angola and stayed there until 2nd December 2012. On 26th January 2013, he travelled to Canada to see his family and stayed there till 7th September 2013. On 1st May, 2014, he moved into his house in Dar es Salaam which he had bought on 28th September 2013. Before moving into his house, he had been renting a two-bedroom house since 1st January, 2014. On 21st December, 2014, the government of Uganda hired him to work in the embassy of Uganda in South Africa where he has been staying to date. The Ugandan appointment forced him to sell his residential house in Dar es Salaam on 26th December 2014.

Required:

Use section 66 of the Income Tax Act, Cap 332 to determine the residential status of Mr. Kamar for the years of income 2011, 2012, 2013, 2014 and 2015.

(b) Section 6 (2) of the Income Tax Act, Cap 332 provides that:

"The chargeable income of a resident individual who at the end of a year of income has been resident in the United Republic for two years or less in total during the whole of the individual's life shall be determined under subsection (1) (b)".

REQUIRED:

Discuss the implication of the above provision.

Question 8

(a) Explain "the test of residence of an individual" as enshrined under Section 66 of the Income Tax Act, Cap. 332 (R.E. 2014).

(b) What is the significance of classifying a person as resident in the United Republic of Tanzania (URT) for income tax purposes?

Answers to Self-Examination Questions

Answer to SEQ 1

YOI	Celina	Chichi	Christie
2010	**Resident** (was in URT more than 183 days in the YOI)	**Resident** (was in URT more than 183 days in the YOI)	**Resident** (was in URT more than 183 days in the YOI)
2011	**Non resident**(present less than 183 days and not present in 2009)	**Non resident**(present less than 183 days but not present in 2009)	**Non resident**(never present in URT in the YOI)
2012	**Non resident**(average days for 2012, 2011 and 2010 less than 122)	**Resident** (average days for 2012, 2011 and 2010 more than 122)	**Non resident**(not present in 2011)
2013	**Non resident**(average days for 2013, 2012 and 2011 less than 122)	**Resident** (average days for 2013, 2012 and 2011 equal to 122)	**Non resident**(not present in 2011)

Answer to SEQ 2

a) To assess is to determine the taxable income through computation and adjustment of various sources of income while to charge is to apply the tax rate on the assessed value.

b) Exempt income and income exempt are both not taxable. Exempt income is income not taxed because the source is exempt. While income exempt is income not taxed because of the application of the law, order or rule or because of certain circumstances, it is derived from a taxable source (e.g. president of the URT salary). Exempt income does not form part of the total income to be included in the income tax return.

c) A person means an individual or an entity such as a company or trust whereas an individual means a natural person.

d) Benefit in kind is income received in non-monetary terms such as free use of employer's motor car, accommodation. Benefit in cash on the other hand is income received or to be received in monetary terms e.g. salary, interest, dividend etc.

e) An entity is a broader term that means a partnership, trust or corporation. A corporation means any company or body corporate established, incorporated in the United Republic or elsewhere, an unincorporated association or other body of persons, a government, a political subdivision of a government, a parastatal organisation, a public international organisation and a unit trust but excludes a partnership.

Answer to SEQ 3

In order to determine the residential status of a Chinese company which has been operating in Tanzania since January 2011 the following factors needs to be considered:

a) Whether the Chinese company incorporated or formed under the laws of the United Republic; if yes then it is a resident
b) Whether the management and control of the affairs of the corporation exercised during the year of income were conducted in the United Republic of Tanzania. If yes, then the Chinese company would be a resident.

Answer to SEQ 4

The basis periods for the entity are:
Y/I Basis periods
2012 01.07.2012– 31.12.2012 (6 months)
2013 01.01.2013 – 31.12.2013 (12 months)*
2014 01.04.2013 – 31.03.2014(12 months)*
(*Overlapping period: 01.04.2013 – 31.12.2013)
The adjusted income of the business should be apportioned as follows:

Y/I & Basis period	**Apportionment**	**Adjusted income**
2012 (01.07.2012 – 31.12.2012)	01.07 – 31.12.2012: (6 / 9 x Sh.15, 000m.)	**TZS 10, 000m**
2013 (01.01.2013– 31.12.2013)	01.01 – 31.03.2013: (3 / 9 x Sh.15, 000) 01.04 – 31.12.2013: 9 / 12 x Sh.24, 000)	**TZS 23, 000m**
2014 (01.04.2013 – 31.03.2014)	Adjusted income of overlapping period (01.04.2013 – 31.12.2014) ignored in second basis period: (Sh24, 000m – Sh.18, 000m)	**TZS 6, 000m**

Answer to SEQ 5

(i) Taxability in United Republic of Tanzania (URT)
2 conditions, either:

- The income has a source in the URT, or,
- The person is resident in the URT for the year of income relating to the income

(ii) Taxability of her income in Tanzania

The income is taxable in the URT because she is resident (has a permanent home and was present in URT for part of 2015)

(iii) Disadvantage??

- As a resident person in URT, Louise is eligible for section 77 foreign tax credit.
- In case the tax rate on the income in Sweden is lower than or equal to the one applying in URT, no disadvantage

Answer to SEQ 6

(i) Mr Judah was resident of United Republic of Tanzania for the year of income 2013

Reasons:

- Has permanent home in URT
- He was present in URT during the year of income 2013

(ii) Ms Cathie was resident in Tanzania for the year of income 2013

Reasons:

- She stayed in URT for periods amounting to 205 days for the year of income 2013 which is more than 183 days
- She was present in URT during the year of income 2013

(iii) Mrs Pakutokea was resident of URT during the year of income 2013

Reasons:

- Mrs Pakutokea is employed by Tanzania Government and has been posted at Tanzania Embassy in Tokyo Japan since 01/08/2012. Though she didn't come to Tanzania during the year of income 2013, she is an official of the Government of the United Republic of Tanzania posted abroad. She is treated as resident in Tanzania during the year of income 2013

Answer to SEQ 7

(a)

- A non-resident person for tax purposes means a person who has been physically in URT but does not qualify to be a resident and charge the Worldwide income as per section 66 of the ITA, 2004.
- A person who is not a resident means a person who is not a Tanzanian and is not physically in URT for any part of the Year of Income.

(b) For 2011

He stayed for 212 days i.e.

June (28 days) + July (31 days) + August (31 days) + September(30 days) + October(31 days) + November (30 days) + December (31 Days) therefore he is a resident of URT.

For 2012

He was physically present in URT for 87 days (i.e. January (31 days) + February (27 days) + December (29 days) and he has no permanent home, therefore he is non-resident.

For 2013

He was physically present in URT for 140 days in 2013 + 87 days in 2012 + 212 days in 2011; with the average of 146 days in three years therefore he is a resident.

For 2014

He was physically present in URT and he has a permanent home therefore he is a resident.

For 2015

He was not physically present in URT and he has been employed by a different government therefore he is not a resident.

(iii) This provision implies that if a person has been a resident for only two years, or less then he has to be treated as a non-resident and thus the person shall only be taxed for income whose source is in URT.

Answer to SEQ 8

(a) An individual is said to be resident of United Republic of Tanzania (URT) for a year of income if he/she:

i. has a permanent home in UR and present at any part of the Year of Income (YOI) or
ii. is present in URT during the YOI for a period(s) amounting in aggregate to at least 183 days or
iii. is present in URT during the YOI and in each of the two preceding years of income for a period averaging more than 122 days during each YOI

iv. is an employee or an official of the Government of URT working abroad during the YOI.

(b) The significance of classifying a person as resident in the United Republic of Tanzania for income tax purposes as under s.6 of ITA 2004 are:

(i) **Scope of chargeability (Scope of Income liable to tax)**
The chargeable income of a person for a year of income shall be:

1. In the case of a resident person, the person's income from employment, business or investment for the year of income irrespective of the source of the income; and

2. In the case of a non-resident person, the person's income from the employment, business or investment for the year of income, but only to the extent that the income has a source in the URT.

3. The income of a resident person without a permanent home in Tanzania and who at the end of the year of income has been resident in the United Republic for two years or less in total during the whole of the individual's life shall be chargeable to tax only on the income that has a source in Tanzania.

(ii) Allowances and relief in respect of capital deductions and exemptions.

(iii) Tax credit on double taxation as only provided to resident persons.

SECTION C

INCOME TAX

C2

STUDY GUIDE C2: PRINCIPLES OF DEDUCTION

Get Through Intro

In calculation of chargeable income from employment, business and investment it may be allowed to deduct certain expenditures incurred in generating such and income. In this Study Guide we learn the principles related to deduction of expenditures in calculating chargeable income from employment business and investment.

Learning Outcomes

a) Explain the general principle of deductions.
b) Identify the specifically allowable deductions.

1.0 Explain the general principle of deductions and identify the specifically allowable deductions

[Learning outcome a and b]

1. General Principle Of Deductions In Business Income

Then after knowing elements which constitute business income the next step is to understand deductible business or investment expenses. In fact it is very important to understand these allowable expenses because they affect how much is left for business/investment income taxes.

In general all expenses incurred 'wholly and exclusively' in the production of income are allowable expenses (Section 11(3)). Therefore, only expenditure incurred for sole purposes of producing business/investment income are allowable expenses and expenditure incurred not wholly and exclusively for business/investment purposes are not allowable.

However, deduction of capital, consumption and excluded expenditures is not allowed (Section 11). Yet, the capital expenditures on depreciable assets are deductible in form of depreciable annual allowance under the third schedule Income Tax Act 2004. Therefore, depreciation charges calculated under taxpayers' accounting policies are not allowed too.

Definitions

'**Consumption expenditure**' means any expenditure incurred by any person in the maintenance of himself, his family or establishment, or for any other personal or domestic purpose.

"**Expenditure of a capital nature**" means expenditure that secures a benefit lasting longer than twelve months;"

'**Excluded expenditure**' means:

a) tax payable under this Act except skills and development;
b) bribes and expenditure incurred in corrupt practice;
c) fines and similar penalties payable to a government or a political subdivision of a government of any country for breach of any law or subsidiary legislation;
d) expenditure to the extent to which incurred by a person in deriving exempt amounts or final withholding payments;
e) distributions by an entity or

Distribution by an entity:

a) means:
   i] a payment made by the entity to any of its members, in any capacity to the extent that the amount of the payment exceeds the amount of any payment made by the member to the entity in return for the entity's payment; or
   ii] any re-investment of dividends which enhances the value of shares
   iii] any capitalisation of profits;

b) includes a payment made by the entity to one of its members on cancellation, redemption or surrender of a membership interest in the entity, including as a result of liquidation of the entity or as a result of the entity purchasing a membership interest in itself;
c) excludes a payment of the type referred to in paragraph (a) (i) or (b):
   i] to the extent to which the payment is directly included in calculating the member's income or in calculating a final withholding payment, other than by reason of being a distribution; and
   ii] without limiting any amount treated as a distribution by paragraph (a)(ii), that consists of the issue of further membership interests in the entity to the entity's members in approximate proportion to the members' existing rights to share in dividends of the entity; and
d) In the case of a controlled foreign trust or corporation, is interpreted in accordance with Section 75.

2. Specific Allowable Deductions

2.2 Interest expense

Interests bearing external financing activities are normal in any business or investment venture. Therefore, Interest incurred by a person during a year of income under a debt obligation shall be considered to have been incurred wholly and exclusively in the production of income from a **business or investment** if the debt obligation was incurred wholly and exclusively in the production of income from the business or investment. Likewise, interest incurred on non-monetary debts is also deductible when the debt obligation was incurred wholly and exclusively in the production of income from the business or investment (Section 12(1)(b)). However, when interest incurred on foreign currency debt obligation is deductible only when they are actually paid (39(g)).

Nevertheless, interest expenses incurred wholly and exclusive in production of **business or investment** income for exempt controlled resident entity are restricted. In fact, interest expenses deducted by an exempt-controlled resident entity must not exceed sum of interest equivalent to debt-to-equity ratio of 7 to 3 (Section 12(2). In case of changes in debt or equity amounts; the amount of the equity or debt should be the average of balances of amount of debt or equity at the end of each period (Section 12(4)).

Definitions

'An exempt-controlled resident entity' for a year of income if it is resident and at any time during the year of income 25% or more of the underlying ownership of the entity is held by entities exempt under the Second Schedule, approved retirement funds, charitable organisations, non-resident persons or associates of such entities or persons.

Section 12(4)

'Debt' means any debt obligation excluding: a non-interest bearing debt obligation, a debt obligation owed to resident financial institution and a debt obligation owed to a non-resident bank or financial institution on whose interest tax is withheld in the United Republic. While

'equity' includes: paid up share capital, paid up share premium and retained earnings on an unconsolidated basis determined in accordance with generally accepted accounting principles.

Section 12(5)

'Period' means a month or part of month

Section 12(5)

'Parastatal organisation' means: a local authority of the United Republic, a body corporate established by or under any Act or Ordinance of the United Republic other than the Companies Act, and any company registered under the Companies Act where –

a) in the case of a company limited by shares, not less than 50 percent of the issued share capital of the company is owned by the Government or an organisation which is a parastatalorganisation under this definition; or
b) in the case of a company limited by guarantee:
   i] the members of the company include the Government or an organisation which is a parastatal organization under this definition; and
   ii] such members have undertaken to contribute not less than 50 percent of the amount to be contributed by members in the event of the company being wound up.

Section 12(5)

2.3 Trading stock allowance

Costs of goods sold are tax deductible **business** expenses. They are calculated by taking the opening value of trading stock of the business for the year of income; plus expenditure incur red by the person during the year of income that is included in the cost of trading stock of the business; less the closing value of trading stock of the business for the year of income (Section 13(2)). The closing stock should be valued at the lower of the cost of the trading stock of the business at the end of the year of income; or the market value of the trading stock of the business at the end of the year of income (Section 13(4).

Definition

The opening value of trading stock of a business for a year of income is the closing value of trading stock of the business at the end of the previous year of income.

Section 13(3)

2.4 Repair and maintenance expenditure

Revenue expenses incurred on repair and maintenance of **depreciable assets** owned and employed by the person wholly and exclusively in the production of income from the **business** are deductible. But, expenditures incurred to improve lives of assets or repairs and maintenance of capital nature should be capitalised in the costs of assets rather than be deducted as revenue expenses (Section (14)(2)).

2.5 Agriculture improvement, research development and environmental expenditure

Agriculture improvement, research development and environmental expenditure are deductible expenses when incurred for **business** purposes (Section 15 (1)). In addition mining business might make a provision allowance account under environmental expenditure and apply for their deductions to the Commissioner; if approved they become deductible expenses (Section 15(3)).

Definitions

'**Agricultural improvement expenditure'** means expenditure incurred by the owner or occupier of farm land in conducting an agriculture, livestock farming or fish farming business where the expenditure is incurred in clearing the land and excavating irrigation channels; or planting perennial crops or trees bearing crops.

'Environmental expenditure' means expenditure incurred by the owner or occupier of farmland for prevention of soil erosion";

'Research and development expenditure' means expenditure incurred by a person in the process of developing the person's business and improving business products or process and includes expenditure incurred by a company for the purposes of an initial public offer and first listing on the Dar es Salaam Stock Exchange but excludes any expenditure incurred that is otherwise included in the cost of any asset used in the use in any such process, including an asset referred to in paragraph 1(3) of the Third Schedule .

From definitions of agriculture improvement expenditure, the expenditure can be deducted by a person conducting agriculture business while, environmental expenditure are deductible by both those in agriculture for the reason explained in the definitions. Finally, the research and development expenditure can be deducted by any type of business.

Definition

'Agricultural business' means the practice of rearing of crops or animals including forestry, beekeeping, acqua-culture and faming with a view to deriving a profit but excludes extraction of natural resources o processing of agricultural produce other than preparing such produce for the purpose of sale in its original form.

2.6 Contribution and donations

Contribution and donations made by taxpayers are generally not incurred wholly and exclusive for business purposes, then generally all these expenses should not be deducted. However, contribution and donations made under Section 12 of the Education Fund Act and amount paid to local government authority, which are statutory obligations to support community development projects, are deducted 100%. Conversely, deduction of amounted contributed to a charitable institution or social development project should not exceed 2% of the person's income from the business calculated without such deduction (Section 16(2).

'Charitable organisation' means a resident entity of a public character that satisfies the following conditions:

(i) the entity was established and functions solely as an organisation for: the relief of poverty or distress of the public, the advancement of education or the provision of general public health, education, water or road construction or maintenance; and
(ii) the entity has been issued with a ruling by the Commissioner under Section 131 currently in force stating that it is a charitable organisation or religious organisation.

Others donations and contributions can only be deducted if they are incurred wholly and exclusively for the purposes of business. For instance, contributions to trade organisations can be deductible if the trade association furthers the businesses of its members (Lochgelly Iron and Coal Co Ltd v Crawford [1913] 6 TC 267). Similarly, contribution to charitable organisations of clothes with businesses' advertisements or to support exhibition might qualify as deductible expenses (Morley v Lawford [1928] 14 TC 229). Also costs incurred on businesses entertainment for the purposes of business might be allowable expenses (Bentleys Stokes & Lowless v Beeson [1952] 33 TC 491).

2.7 Depreciation allowances for depreciable assets

Depreciation allowance for depreciable assets owned and employed by the person during the year of income wholly and exclusively in the production of the person's income from the business the allowances granted under the Third Schedule of the Income Tax Act Cap 332 is allowable expenses (Section 17); this part is covered in the next Section. So, depreciable allowance of depreciable assets basing on taxpayer's accounting policies is not deductible.

2.8 Losses on realisation of business assets and liabilities

Losses from realisation of a business asset of the business that is or was employed wholly and exclusively in the production of income from the business; a debt obligation incurred in borrowing money, where the money is or was employed or an asset purchased with the money is or was employed wholly and exclusively in the production of income from the business; or a liability of the business other than a debt obligation incurred in borrowing money, where the liability was incurred wholly and exclusively in the production of income from the business are all deductible expenses (Section 18).

2.9 Losses from a business or investment

Similarly losses incurred by businesses with exceptional of partnership or a foreign permanent establishment are deductible expenses. These losses include any unrelieved loss of the year of income of the person from any other business and any unrelieved loss of a previous year of income of the person from any business (Section 19(1)).

Additionally, unrelieved losses from other foreign source losses can be deducted only in calculating the person's foreign source income and unrelieved loses from agriculture business can only be deducted from calculating business income from agriculture.

Definition

'Loss' of a year of income of a person from any business or investment is the excess of amounts deducted in calculating the person's income from the business or investment over amounts included in calculating such income.

'**Unrelieved loss'** means the amount of a loss that has not been deducted in calculating a person's income.

2.10 Capital receipts

Proceeds from sale of depreciable assets would be treated in computation of gain from realisation of depreciable assets as required in the schedule of the Income Tax Act ,Cap 332. Likewise, receipts from disposal of investment income should be used in calculating investment capital gain and the investment income not in computing business income.

2.11 Foreign currency exchange gain

Gain or loses from foreign exchanges if related to business transactions are taxable income and deductible expenses respectively. Yet the computation of foreign exchange gains should be done when there is actual receipt of the foreign currency. Because it is at that point the foreign currency debt is realised (Section 40(2) (c)). Nevertheless exchange gains or losses on translation of foreign owned operation are not allowed.

2.12 Insurance claims

When there are receipts from insurance compensation relating to depreciable assets; they should be treated as incoming from realisation of the depreciable assets and used from computation of gain or loss from realization of depreciable assets. Also insurance compensation relating to investment assets are used in computing capital loss or gain from that investment assets. However, any receipt of insurance against current assets, business losses and other accident are taxable business income.

2.13 Legal and accountancy charges

Expenses incurred in preparation of financial accounts and tax returns are generally allowable expenses.

However, legal and expenses incurred in tax appeal are not deductible (Smiths Potato Estates Ltd v Bolland1948 30 TC 267). In that case, the judge argued that they not incurred wholly and exclusive in production of income but in ascertaining tax liabilities therefore the expense were disallowed.

2.14 Business entertainment and gifts

Expenses and gifts incurred in entertaining employees in relationship to their employment are generally allowed as they constitute employment income. But, those expenses incurred for non-employee persons are disallowed expenditures if they are not wholly and exclusively incurred for businesses purposes.

2.15 Pension scheme contributions and other employee benefits

Payment made to both approved and unapproved pension schemes and other employee' benefits are deductible businesses expenses so long as they payments are included in calculations of employment income (Income Tax Regulation 4). In addition, any employment benefits as training costs and redundancy incurred by employers are deductible expenses provided they are included in employees' income.

2.16 Legal and other expenses

Legal and other expenses in connection with normal business or investment activities and they are incurred wholly and exclusive for business purpose are deductible expenses. However, those expenses incurred in connection of acquisition of capital assets should be capitalised in the costs of assets and therefore they are not deductible expenses (Section 37).

2.17 Other losses and defalcations

Only losses from business or investment activities incurred wholly and inclusive for businesses purposes are allowable expenditures. These losses might include fire, burglary, accident and loss of profits and when there is insurance against them insurance costs are deductible too. However, losses arising from loss of capital assets are not straight deductible from business income. They have either to go to the computation of gain or loss from realisation of business, depreciable or investment assets. But, insurance expenses against depreciable assets are allowable expenses.

On the other hand, when employees defraud their employers the loss incurred is deductible expenses, while defalcations by directors, sole traders or partners in partnership are not deductible (Curtis v J & G Oldfield Ltd [1925] 9 TC 319). In this case, the judge argued that misappropriations of assets by persons in control of businesses are allocations of profit of the businesses not trade activities of the businesses; therefore these losses are not deductible.

2.18 Bad and doubtful debts

Businesses' bad debts of revenue nature are deductible expenses when they become bad and actually written off (Section 25(4); Section 39). Therefore, general provision for doubtful debts is not deductible expenses. Yet, provision for specific doubtful debt may be allowed. Furthermore, a bad debt arising out of business or investment activities and its associated costs is not allowable (Curtis v J & G Oldfield Ltd [1925] 9 TC 319).

Self-Examination Questions

Question 1

Samaria Enterprises, super dealers of construction products, has recently constructed its office premises. The company incurred TZS 45,000,000 for planting of grasses, fruit trees, other trees, and flowers in the surroundings of the premises. Samaria is claiming a deduction for this expenditure on the basis that it is an agricultural expenditure.

Required:

Comment on the Samaria claim

Question 2

KekoLtd, owns a factory which produces textile products. The chemicals released by the factory have been claimed to be affecting the environment. Keko Ltd has thus incurred TZS 34,000,000 to clean the environment claimed to have been affected by the chemicals. The company claims deduction of such expenditure claiming that it is environmental expenditures.

Required:

Is Keko Limited claim right?

Question3

Explorers Ltd has won a contract to explore oil and gas along the Tanzania's Indian Ocean shore. The company claims, for taxation purposes, deduction of all the costs of renting exploration ship and surveying costs which amounts to TZS 300,000,000,000 per year. Moreover the company is claiming deduction of underwriting fees at DSE for issue of final round of its ordinary shares. On top of that the company further claims a deduction of TZS 15,000,000 consultancy fees for formulation of office regulations and procedures. The company's claim for deduction is based on the fact that all these expenditures are research and development expenditures.

Required:

Comment on the validity of the claims.

Question 4

A foreign parent company, AMADEUS LIMITED has a loan of TZS.40,000,000 to its wholly-owned subsidiary in Tanzania, Amazon Tanzania Limited. Amadeus Limited's equity in Amazon Tanzania Limited is TZS.2,000,000 and interest payable on the debt for the 2019 year of assessment is TZS.6,000,000.

Required:

Determine the interest that should be allowed for tax purposes in 2019 year of assessment for Amazon Tanzania Limited. Explain your answer.

Question 5

Company ADC Ltd was incorporated in 2008 and engaged in construction and consultancy services.

The following information were extracted for the company's return of income for 2019 year of income:

Consultancy fee TZS 20m

Gross income (construction) TZS 300m

Expenses (allowable) TZS 150m

Donation to Education Fund (TEA) TZS 50m

Paid Sh. 10m/= to a charitable organization which is dealing with HIV affected children.

For the rehabilitation of a local dispensary TZS 50m

Donation to a charitable institution for construction of two Classrooms at cost TZS 25m

Required

Calculate the Taxable Business Income for 2019.

Question 6

In calculating income from business, the Income Tax Act, Cap 332 requires a certain treatment for unrelieved losses.

Required:

(i) Explain the treatment of unrelieved losses for tax purposes.

(ii) Explain the rationale for the treatment of unrelieved losses you dealt with above.

(iii) State the exception to the treatment you explained in (i) above and its rationale.

Answers to Self-Examination Questions

Answer to SEQ 1

Persons who may claim deduction with respect to agricultural expenditure are those dealing with agriculture, livestock farming or fish farming business. Moreover the expenditure must have been incurred in respect of clearing land, construction of irrigation channels, planting of perennial crops or trees bearing crops.

Samaria is a dealer of construction product and not a dealer in agriculture, livestock farming or fish farming business. This disqualifies Samaria from claiming deductions as agricultural expenditure. Moreover, the planting of grasses, trees bearing no crops, and flowers still do not amount to the like of things which when planted may make an expenditure deductible as an agricultural expenditure. Furthermore, even the planting of fruit trees around the office premises may not amount to agriculture in its own.

Answer to SEQ 2

Environmental expenditure may exist whenever one incurs expenditure to prevent soil erosion. Therefore, expenditures to clean environment after being contaminated with chemical do not amount to environmental expenditure at all.

Answer to SEQ 3

Research and development expenditure may be categorized in the following:

- Expenditures to establish a business e.g. incorporation costs, cost to set up organization's systems, procedures, and regulations – including cost to issue IPO and first listing of shares and securities at the DSE. The expenditure shall not be associated with asset acquisition used in such process of business establishment.
- Expenditures to develop a new product or new process or improvement of the existing product or process

Back to the expenditure incurred by Explorer:

- Ship renting expenditure is related with exploration. It is thus a research and development expenditure.
- The only expenditure in respect of share listing at the DSE which are regarded Research and Development expenditure are those related to the IPO or first secondary listing. Therefore, expenditure to list the final round of secondary listing cannot be regarded research and development expenditure.
- Expenditures to develop new or improved business regulations and procedures qualify to be regarded as research and development expenditure.

Answer to SEQ 4

Determination of Allowable Interest – 2019 Year of Assessment

Interest allowable shall not exceed debt to equity ratio of 7:3 as provided for under thin capitalization rules. Amadeus Limited is an exempt person with Amazon Limited being an exempt-controlled resident entity. So with an equity of TZS.2,000,000, the interest payable on the debt of TZS.40,000,000 has to be subject to the thin capitalization rule.

Interest charged	
Equity Investment	2,000,000
Maximum Exempt Loan Allowed	7/3x 2,000,000 = 4,666,667

Interest Allowed

$$\frac{7 \text{ x Equity x Interest Charged}}{3 \text{ x Total foreign loan from parent company}} = \frac{7 \text{ x } 2{,}000{,}000 \text{ x } 6{,}000{,}000}{3 \text{ x } 40{,}000{,}000}$$

= 700,000

Answer to SEQ 5

Solution	
Income	
Construction	200
Consultancy	120
Total Income	320m
Less:	
Operational and financial expenses	(150m)
	170m
Donation to Education Fund (TEA)	(50m)
Balance	120m
Other donations	
Other contrs. 2% of 120m – (2.4m/=)	2.4m
Taxable income	117.6m

Note:

Education Fund contribution allowed in full. Other contributions to charities ceiling is 2% of the income before the deduction.

Answer to SEQ 6

Unrelieved loss

(i) Treatment for tax purposes
Unrelieved loss from one business can be deducted from another business, and unrelieved loss for the same business from a previous year of income is deductible for the year of income.

(ii) Rationale

- The rational is to allow businesses some time, especially in initial years, to recover the losses suffered before actually levying income tax on the businesses.

- Ideally, if the objective is to tax the profit, then the unrelieved losses comes only as a result of having the business divided into years of income for administrative purposes.

- Allowing a deduction for unrelieved losses essentially ensures that what is eventually taxed is purely the gains or profits from the business.

(iii) Exception
An exception to the treatment of unrelieved losses exist, for corporations, in which case where they make losses for 3 consecutive years, if it makes a loss in the 4^{th} year, the corporation will be liable to tax, which will be based on turnover.

The rationale for this is that 5 years is considered adequate for a venture to make turn around, and since it enjoys the public services from the state, it should somehow contribute to the same.

STUDY GUIDE C3: REALIZATION OF ASSETS AND LIABILITIES

Get Through Intro

Assets and liabilities may transfer hands from one owner to another on either business, investment or other purposes. The gains or losses may be made. In this Study Guide we learn how to calculate gain or loss from realization of assets and liabilities.

Learning Outcomes

a) Explain the rules relating to calculation of gain/loss of assets and liabilities
b) Explain the rules relating to realisation of assets and liabilities.
c) Determine the incomings and cost of assets and liabilities.
d) Explain special rules on deemed realisation

1.0 Explain the rules relating to calculation of gain/loss of assets and liabilities and explain the rules relating to realisation of assets and liabilities.

[Learning outcome a and b]

1. Rules Relating To Calculation Of Gain/Loss Of Assets And Liabilities

The need to calculate gains or losses on realisation of assets or liabilities for taxation purposes is established in many provisions of the Income Tax Act, Cap 332. e.g section 8 (2) (c) requires the inclusion of gains from the realisation of business assets or liabilities of the business in calculating a person's gains or profits from conducting a business for a year of income. While section 18 grant the deduction in respect of any loss of the person, from the realisation during the year of income of :-

(a) a business asset of the business that is or was employed wholly and exclusively in the production of income from the business;
(b) a debt obligation incurred in borrowing money, where the money is or was employed or an asset purchased with the money is or was employed wholly and exclusively in the production of income from the business; or
(c) a liability of the business other than a debt obligation incurred in borrowing money, where the liability was incurred wholly and exclusively in the production of income from the business.

1.1 Calculation of gain (loss):

- a person’s gain from the realization of an asset or liability is the amount by which the sum of the incomings from the asset or liability exceeds the cost of the asset or liability at the time of realization
- a person’s loss from the realization of an asset or liability is the amount by which the cost of asset or liability exceeds the sum of the incomings (amount received) for the asset or liability at the time of realization

1.2 Net gains from the realization of investments assets

Section 36(3) provides the basis of calculating net gains from the realization of investment assets of an investment of a person for a year of income. The net gains are the sum of all gains from the realization of investment assets of the investment during the year reduced by:-

(a) The total of all losses from the realization of investment assets of the investment during the year

(b) Any unrelieved net loss of any other investment of the person for the year; and

(c) Any unrelieved net loss for a previous year of income of the investment or any other investment of the person..

Example

Mr. Mapana a resident individual owns various investment assets, including shares in companies A, B, C and D and interest inland and buildings. During the year of income he disposes of some of his shares in the companies as indicated below. Calculate the net gain received on realization of those shares.

Coy shares	**Sale Price**	**Cost**	**Gain/(Loss)**
Coy A shares	TZS. 17,000,000	TZS. 15,800,000	TZS. 1,200,000
Coy B shares	TZS. 26,100,000	TZS. 25,000,000	TZS. 1,100,000
Coy C shares	TZS. 18,000,000	TZS. 18,200,000	TZS. (200,000)
Coy D shares	TZS. 16,400,000	TZS.16,500,000	TZS. (100,000)

Unrelieved net loss from realization of investment assets previous year 200,000

Calculation of net gains from the realization of investment assets of an investment of a person for a year of income is calculated as illustrated in the following example:- (All companies are resident in the United Republic)

Gains obtained from sale of shares in Company **A**	TZS.	1,200,000/=
Gains obtained from sale of shares in Company **B**	TZS.	1,100,000**/=**
Total	**TZS.**	**2,300,000/=**

Less: Total losses from realization of investment asset

Loss obtained from sale of shares in company **C**	200,000
Loss obtained sale of shares in company **D**	100,000
	300,000

Less: Unrelieved net loss from realization of investment assets previous year		200,000	
			500,000/=
Gains to be included in calculating total income (S. 9(2) (b))	Shs.		**1,800,000/=**

The sum of losses incurred in realization of the shares in companies C and D are set off against the gains derived from the realization of shares in companies A and B.

2. Rules Relating To Realisation Of Assets And Liabilities.

2.1 Realization of Assets

Realisation of assets is dealt with Section 39. According to this Section an asset is said to have been realized when:

a) the person parts with ownership of the asset including when the asset is sold, exchanged, transferred, distributed, cancelled, redeemed, destroyed, lost, expired or surrendered. This part does not apply to assets of deceased individuals.
b) in the case of an asset of a person who ceases to exist, excluding a deceased individual, immediately before the person ceases to exist;
c) in the case of an asset other than a Class 1, 2, 3, 5, 6 or 8 depreciable asset or trading stock, where the sum of the incomings for the asset exceeds the cost of the asset;
d) in the case of an asset that is a debt claim owned by a financial institution, when the debt claim becomes a bad debt as determined in accordance with the relevant standards established by the Bank of Tanzania and the institution writes the debt off as bad;
e) in the case of an asset that is a debt claim owned by a person other than a financial institution, the person reasonably believes the debt claim will not be satisfied, the person has taken all reasonable steps in pursuing the debt claim and the person writes the debt off as bad;
f) in the case of an asset that is a business asset, depreciable asset, investment asset or trading stock, immediately before the person begins to employ the asset in such a way that it ceases to be an asset of any of those types;
g) in the case of a foreign currency debt obligation, when such debt is actually paid;
h) in the case of an asset owned by an entity whose the underlying ownership of an entity changes by more than 50% as compared with that ownership at any time during the previous three years, the entity would be treated as realising any assets owned by it immediately before the change.

From the definition of realisation of assets above, it can be said that an asset is realised when it is written off from accounting records because of transaction that lead to transfer of risks and rewards associated with the asset. Also, realisation of assets occurs when a transaction leads to reduction of value of assets because of significant change in risks and rewards over an asset there is realisation of the assets.

However, decrease in value of assets because of depreciation or impairment loss does not result in realisation of assets because the decrease does no result from transaction. Yet, besides realisation of assets through transactions it is possible to realise an asset on occurrence of events like fire, thieves and others mentioned above.

Definition

'Underlying ownership', in relation to an entity, means membership interests owned in the entity, directly or indirectly through one or more interposed entities, by individuals or by entities in which no person has a membership interest; or in relation to an asset owned by an entity, means the asset owned by the persons having underlying ownership of the entity in proportion to that ownership of the entity.

Section 3

‘Asset’ means a tangible or intangible asset and includes currency, goodwill, know-how, property, a right to income or future income and a part of an asset.

Section 3

‘Corporation’ means any company or body corporate established, incorporated or registered under any law in force in the United Republic or elsewhere, an unincorporated association or other body of persons, a government, a political subdivision of a government, a parastatalorganisation, a public international organisation and a unit trust but excludes a partnership.

Section 3

‘Business asset’ means an asset to the extent to which it is employed in a business and includes a membership interest of a partner in a partnership but excludes:

a) trading stock or a depreciable asset;
b) an interest in land held by an individual that has a market value of less than 10 million shillings at the time it is realised and that has been used for agricultural purposes for at least two of the three years prior to realisation;
c) the beneficial interest of a beneficiary in a resident trust; and
d) shares and securities listed on the Dar es Salaam Stock Exchange that are owned by a resident person or by a non-resident person who either alone or with other associates controls less than 25% of the controlling shares of the issuer company.

Section 3

‘Depreciable asset’ means an asset employed wholly and exclusively in the production of income from a business, and which is likely to lose value because of wear and tear, obsolescence or the passing of time but excludes goodwill, an interest in land, a membership interest in an entity and trading stock.

Section 3

‘Entity’ means a partnership, trust or corporation.

Section 3

‘Foreign currency debt claim’ means a debt claim that is denominated in a currency other than Tanzanian shillings.

Section 3

On the other hand realisations of liabilities are regulated by Section 40(2) of the Income Tax Act 2004. Actually liabilities of a person are deemed realised when:

a) the person ceases to owe the liability including when the liability is transferred, satisfied, cancelled, released or expired. This part does not apply to liabilities of deceased individuals
b) in the case of a liability of a person who ceases to exist, excluding a deceased individual, immediately before the person ceases to exist;
c) in the case of a foreign currency debt obligation, when such debt is actually paid.
d) in the case of a liability of an entity whose underlying ownership of an entity changes by more than 50% as compared with that ownership at any time during the previous three years, the entity is treated as realizing any liabilities owed by it immediately before the change; and
e) in the case of a liability owed by a resident person, immediately before the person becomes a non-resident person, other than liabilities owed by the person through a permanent establishment situated in the United Republic immediately after becoming non-resident.

Determine the incomings and cost of assets and liabilities and explain special rules on deemed realization

[Learning outcome c and d]

3. Incomings And Cost Of Assets And Liabilities

3.3 Incomings from realisation of assets and incurring liabilities

Specifically, incomings from realisation of an asset of a person means amounts derived by the person in respect of owning the asset including amounts derived from altering or decreasing the value of the asset; and amounts derived under the asset including by way of covenant to repair or otherwise; and amounts derived or to be derived by the person in respect of realising the asset (Section 38). While the incoming from incurring liabilities are the amount derived from incurring the liability (Section 40(1) (b)).

Definition

'Amount derived' means a payment received by a person or that the person is entitled to receive;- Section 3

Example

Robots and Assembler Design makers borrowed money from a bank for the purpose of her business. The loan amount was Tshs14,000,000 but she received Tshs10,000,000 after deduction of bank charges and loan insurance.

Required:

Determine the incoming from incurring the business liability.

Answer

The incoming of liability is the amount received or to be received from the loan, in this case the incoming is Tshs.10,000,000.

3.2 Costs of assets and liabilities

Costs of assets or liabilities represent its monetary values. According to Section 37 and Section 40 costs of assets or liabilities constitute a total of:

(i) expenditure incurred by the person in acquiring the asset including, where relevant, expenditure of construction, manufacture or production of the asset;
(ii) expenditure incurred by the person in altering, improving, maintaining and repairing the asset;
(iii) expenditure incurred by the person in realising the asset or liabilities;
(iv) incidental expenditure incurred by the person in acquiring and realising the asset or liability; and
(v) any amount to be directly included in calculating the person's income; or that is an exempt amount or final withholding payment of the person; but excludes consumption expenditure, excluded expenditure and expenditure to the extent to which it is directly deducted in calculating the person's income or included in the cost of another asset or liability.

Furthermore, the cost of trading stock should not include repair, improvement or depreciation of depreciable assets; and determined under the absorption-cost method (Section 37(1)).

Furthermore, trading stocks should be valued consistently using either the first-in-first-out method or the average-cost method, and these method can be used valuating non-trading stock fungible assets (Section 37(2)).

Definitions

'Absorption-cost method' means the generally accepted accounting principle under which the cost of trading stock is the sum of direct asset costs, direct labour costs and factory overhead costs.
Section 37(7)

'Depreciable asset' means an asset employed wholly and exclusively in the production of income from abusiness, and which is likely to lose value because of wear and tear, obsolescence or the passing of time but excludes goodwill, an interest in land, a membership interest in an entity and trading stock.
Section 3

'Incidental expenditure' incurred by a person in acquiring or realising an asset or liability includes: advertising expenditure, taxes, duties and other expenditure of transfer; and expenditure of establishing, preserving or defending ownership of the asset or liability, and the expenditure referred to any related remuneration for the services of an accountant, agent, auctioneer, broker, consultant, legal advisor, surveyor or valuer. Section 37(7)

Example

The following information relates to the production of certain trading stocks. Your duty is to determine the costs of a single stock if 100,000 of them were produced.

Raw materials	Tshs6,000,000
Labor	Tshs2,000,000
Depreciation costs	Tshs700,000
Repairs	Tshs1,000,000
Other factory overhead	Tshs2,000,000

The costs of trading stocks should not include depreciation or repair costs, so the cost of producing that batch was Tshs10,000,000. Using average cost method the cost of a single stock would be Tshs100.

Still, the costs of inherited assets from deceased individuals are the market values of that asset at the time of such acquisition (Section 37(4)). Likewise, a cost of non-domestic asset of a person who becomes a resident of the United Republic for the first time is the market value of the asset immediately before becoming a resident (37(5)).

4. Special Rules On Deemed Disposal

There are times when although no disposal has actually taken place a person is deemed to have disposed of an asset (taxation concept only). There are special ways of determining costs and incoming of assets resulting from deemed realisation of assets as discussed below:

1. **Realisation with retention of asset**

   When, a person realises an asset of the business in any of the manners described in (d) to (h) above, the realisation is name realisation with retention of assets. However, the person is treated as having parted with ownership of the asset and deriving an amount in respect of the realisation equal to the market value of the asset at the time of the realisation; and the person is treated as reacquiring the asset and incurring expenditure of the same amount (Section 42).

2. **Transfer of asset to spouse or former spouse**

   When there is transfer of assets to spouse or former spouse because of divorce settlement or bona fide separation agreement, an individual transferring the assets is treated as deriving an amount in respect of the realisation equal to the net cost of the asset immediately before the realisation; and the spouse or former spouse receiving the assets is treated as incurring expenditure of the same amount in acquiring the assets (Section 43). However, this Section works on at the discretion of the couple and the couple should apply for this application in writing (Section 43).

   Example

   During the year Mr. Kashumba , divorced his wife, by Court Order he was instructed to transfer some of investments to his wife. He decided to transfer the following

   Land costing Tshs 2,000,000 purchased on 2010, compound wall was constructed for Tshs. 200,000. The compound wall had damaged due to flood and repair cost Tshs 100,000 on 20X3. The neighbor land owner paid Tshs 50,000 for a small piece to make boundary straight.

   Net cost

   In this case, cost= 2,300,000 (2,000,000+200,000+100,000) and incomings is Tshs. 50,000.

   Net Cost is the actual investment of asset at any particular point of time.

i) Net Cost is

	Tshs.
Cost	2,300,000
Less: Incomings	(50,000)
Net Costs	2,250,000

ii) Incoming =Net cost

Therefore Incoming = Tshs 2, 250,000

Gain (loss) =2,250,000-2,250,000=0

Note

The net cost of an asset is the deemed consideration on the disposal by the transferor

3. **Transfer of asset to an associate or for no consideration**
   Except in divorce settlement, any transfer of asset to an associate or for no consideration is treated as realisation of assets at the greater of the market value of the asset or the net cost of the asset immediately before the realisation; and the recipient is treated as acquiring the assets at the same value (Section 44(1)).

Nevertheless, when the transfer involves business asset, depreciable asset or trading stock, by way of transfer of ownership of the asset to an associate of the person and

a) either the person or the associate is an entity;
b) the asset or assets are business assets, depreciable assets or trading stock of the associate immediately after transfer by the person;
c) at the time of the transfer the person and the associate are residents; and the associate or, in the case of an associate partnership, none of its partners is exempt from income tax;
d) there is continuity of underlying ownership in the asset of at least 50 %; and
e) both the person and the associate in writing applied to use this method.

The person making the transfer is treated as deriving an amount in respect of the realisation equal to the net cost of the asset immediately before the realisation and the associate acquiring the assets at the same value (Section 44(2)).

Definitions

'Net cost of a depreciable asset' at the time of its realisation is equal to its share of the written down value of the pool to which it belongs at that time apportioned according to the market value of all the assets in the pool .

Section 44(3)

'Associate' in relation to a person, means another person where the relationship between the two is :

a) that of an individual and a relative of the individual, unless the Commissioner is satisfied that it is not reasonable to expect that either individual will act in accordance with the intentions of the other;
b) that of partners in the same partnership, unless the Commissioner is satisfied that it is not reasonable to expect that either person will act in accordance with the intentions of the other;
c) that of an entity and:
   i] a person who either alone or together with an associate or associates under another application of this definition; and whether directly or through one or more interposed entities, controls or may benefit from 50 percent or more of the rights to income or capital or voting power of the entity; or
   ii] under another application of this definition, is an associate of a person to whom subparagraph (i) applies; or
d) in any case not covered by paragraphs (a) to (c), such that one may reasonably be expected to act, other than as employee, in accordance with the intentions of the other.

Section 3

4. **Involuntary realisation of asset with replacement**
   In case of involuntary realisation of assets either by involuntary sell, exchange, transfer, distribution, cancellation, redeem, destroy, loss, expiry or surrender and replace the asset involuntary realised within a year; the person can be assumed deriving an amount in respect of the realisation equal to: the net cost of the asset immediately before the realisation; plus the amount, if any, by which amounts derived in respect of the realisation exceed expenditure

incurred in acquiring the replacement asset. Addition, the person is assumed incurring expenditure in acquiring the replacement asset equal to the net cost of the asset immediately before the realisation plus the amount, if any, by which expenditure incurred in acquiring the replacement asset exceed amounts derived in respect of the realisation (Section 45). Yet, this Section applies only to taxpayers who apply to the Commissioner to use it.

5. **Realisation by separation**
   Excluding where an asset is transferred under finance lease where the parties derive and incur market value of assets immediately before transfer of the assets (Section 32(5)); where rights or obligations with respect to an asset owned by one person are created in another person including by way of lease of an asset or part thereof, permanently the person is treated as realising part of the asset but is not treated as acquiring any new asset or liability; and when the creation is temporary or contingent, the person is not treated as realising part of the asset or liability but as acquiring a new asset (Section 46).

Deinition

'Lease' means an arrangement providing a person with a temporary right in respect of an asset of another person, other than money, and includes a licence, profit-a-prendre, option, rental agreement, royalty agreement and tenancy, Section 3.

3.3 Apportionment of costs and incomings of assets

Apportionment problem happens when multiple assets are transferred at the same time or in a single deal/price.

In that case, we might be interested in knowing the costs of individual assets. According to Section 47 when multiple assets are acquired or realised the market values of assets at the time of acquisition should be used to apportion the amount incurred or derived. While, when an asset is partly realised the net cost of the asset immediately before the realisation should be apportioned between the parts of the asset realised and the part retained according to their market values immediately after the realisation (Section 47(3).

Example

Robots and Assembler Design Ltd acquired the following assets after paying a single price of Tshs20,000,000:

Asset Market value at the time of acquisition

Car	Tshs7,000,000
Tractor	Tshs6,000,000
Office furniture	Tshs.2,000,000

Required:

Calculate costs of each asset.

Answer

The costs of assets should be apportioned on the market value at the time of acquisition as shown below;

Asset	Tshs	Costs apportioned Tshs
Car	7,000,000	14,583,333
Tractor	600,000	1,250,000
Office furniture	2,000,000	4,166,667
Total	9,600,000	20,000,000

3.4 Gains from the realisation of businesses assets and liabilities

Now we know what constitute costs of assets or liabilities and incoming from realisation of assets or incurring of liabilities. So we can determine gain from realisation of business assets or liabilities. However, those incomings which are exempt amounts or a final withholding payment or incomings from sales of stocks should be excluded (Section 38). The incomings from sales of trading stocks are excluded in computation of gain from realisation of businesses assets because they are used in the calculation of business income and they are legally not business assets.

Definition

'Gain' from realisation of an asset or liability is the excess of the incomings for the asset or liability over the cost of the asset or liability at the time of realisation.

Section 36 (1)

Example

Robots and Assembler Design makers disposed a business asset for Tshs2,000,000 after incurring selling costs of Tshs800,000 and transport expenses of 100,000.

Required:

If the cost of the asset was Tshs400,000, determine gain or loss from the realisation of the assets.

Answer

Gain or loss of realisation of assets = Incomings less cost of the assets less realisation expenses. Therefore,

Gain = Tshs2,000,000 – Tshs800,000 – Tshs100,000 - Tshs400,000 = Tshs700,000.

Self-Examination Questions

Question 1

The following information is provided in connection with realization of investment assets of an investment of Madiba Limited for the three years ended 31st December 2013.

	2015 **TZS**	**2016** **TZS**	**2017** **TZS**
Gains from realization	NIL	20,500,000	150,000,000
Losses from realization	22,500,000	NIL	22,000,000

Required:

i] Compute the net gains/losses from realization of investment assets of Madiba Limited for the years of income 2011, 2012 and 2013.

ii] Briefly explain the tax treatment of the net gains/losses computed above during their respective years of income.

Question 2

MsAmina, a resident individual, has disposed her only residential house located at Mbezi Beach at TZS. 129,000,000 on April 1, 2012. She constructed the building in 2005 through XYZ Constructions Ltd where she was charged TZS 90,000,000. The building permits and architectural design fees cost her TZS 10,000,000. In 2010 she made major renovation of her house which involved construction of servant quarter for TZS 12,000,000 and painting of the old building and replacement of rusted iron sheets for TZS 6,000,000. The disposal costs were 2,000,000.

Required:

i] Calculate the gain/loss on realization of the building.

ii] Determine the tax payable with respect to the gain from realization of the building for the year of income 2012.

iii] Briefly explain the nature of the tax payable under (ii) above.

Question 3

Mrs. Salama disposed the following assets during the tax year ended 31st December 2015:

1. On 1st May 2015, Salama sold a freehold warehouse for TZS.500,000,000. The warehouse was purchased on 1st January 2001 for TZS.250,000,000 and was extended at a cost of TZS.100,000,000 during 2004. In August 2010, the floor of the warehouse was damaged by earthquake and had to be replaced at a cost of TZS.50,000,000. The warehouse was sold because it was surplus to the business's requirements due to the fact that Mrs. Salama purchased a newly built warehouse in 2014. Both warehouses have always been used for business purposes in a wholesale business run by Salama as a sole trader.

1. On 1st November 2015, she sold an acre of land for TZS.15,000,000. She had originally purchased five acres of land on 7th July 2013 for TZS.5,000,000. The market value of the unsold four acres of land as at 1st November 2015 was TZS.55,000,000. The land has never been used for agriculture purposes.

2. On 24th September 2015, she sold 700,000 TZS.100 ordinary shares in CDB Bank Plc whose shares trade at Dar es Salaam Stock Exchange, for TZS.700,000,000. She had originally purchased the 700,000 shares in CDB Bank Plc on 2nd June 2005 for TZS.35,000,000. This shareholding is more than 25% of the CDB Bank Plc's issued shares.

3. On 24th December 2015, she made a gift of her entire holding of 24,000 TZS.400 ordinary shares in MNB Plc., to her daughter-Amina on her graduation day. On that date, the shares were quoted at the Dar es Salaam Stock Exchange at TZS.750. The shares had been purchased on 2nd January 2011 for TZS.12,000,000. Mrs. Salama's shareholding was less than 15% of MNB Plc's issued share capital.

Required:

Calculate the chargeable investment capital gain arising from each of Mrs. Salama's asset disposals during the tax year ended 31st December 2015

Answers to Self-Assessment Questions

Answer to SEQ 1

	2011 TZS	2012 TZS	2013 TZS
Gains from realization	-	20,500,000	150,000,000
Losses from realization	22,500,000	-	22,000,000
Unrelieved net losses from previous year	-	22,500,000	2,000,000
Net Gains (losses) from realization	(22,500,000)	(2,000,000)	126,000,000

The net losses in 2011 (2012) can be carried forward to 2012 (2013) and deducted against any gains from realization

The net gains from realization shall be included in calculation of chargeable income from investment in 2013

Answer to SEQ 2

i] The gain/loss on realization building:

	TZS	TZS
Incomings		129,000,000
Less: Costs		
Construction costs	90,000,000	
Architectural design	10,000,000	
Renovation	12,000,000	
Disposal costs	2,000,000	
		114,000,000
Gain on realization		15,000,000

ii] Amina will have to pay 10% of the gain TZS 15mil as tax which is equal to TZS 1,500,000.

iii] This tax is called single installment tax

Answer to SEQ 3

Name of taxpayer	Mrs Salama
YIO	2015
Computation of taxable investment capital gain	
Item	TZS
Warehouse-for business purpose	-
Land (15,000,000-5,000,000*15,000,000/70,000,000) Note 1	13,928,571
CDB Bank Plc shares (70,000,000-35,000,000)	35,000,000
MNB shares-exempt by Section 3	-
Chargeable investment capital gain	**48,928,571**

Note 1:

Where a person who owns an asset in this case land, realizes part of it, the net cost of the asset (in this case TZS 5,000,000) immediately before the realization shall be apportioned between the part of the asset realized and the part retained according to their market values immediately after the realization (in this case 15,000,000/70,000,000) section 47 (3)) of the Income Tax Act 2004).

SECTION C

INCOME TAX

C4

STUDY GUIDE C4: DEPRECIATION OF DEPRECIABLE ASSETS

Get Through Intro

Depreciation expenses calculated using accounting policies and methods is not an allowable deduction for taxation purposes. One has to calculate depreciation allowance of depreciable assets in accordance with the Income Tax Act Cap, 332, for the allowance to be deductible. This Study Guide introduces you to the rules of calculating depreciation allowance for depreciable assets.

Learning Outcomes

a) Classify depreciable assets
b) Adding depreciable assets in the pool of depreciable assets
c) Calculate depreciation allowances

Classify depreciable assets; adding depreciable assets in the pool of depreciable assets and Calculate depreciation allowances.

[Learning Outcome a, b and c]

1. Depreciable Assets

The Income Tax Act, Cap 332, provides that for the purposes of calculating a person's income from any business, there shall be deducted in respect of depreciable assets owned and employed by the person during the year of income wholly and exclusively in the production of the person's income from the business, the depreciation allowances granted under the Third Schedule to the Act.

1.1 Depreciable assets

Depreciable asset means an asset employed wholly and exclusively in the production of income from a business, and which is likely to lose value because of wear and tear, obsolescence or the passing of time but excludes goodwill, an interest in land, a membership interest in an entity and trading stock.

Classification of Depreciable Assets

There are 8 classes of depreciable assets as far as Income Tax Act Cap 332. These are as follows:

Class 1

Computers and data handling equipment together with peripheral devices, Automobiles, buses and minibuses with a seating capacity of less than 30 passengers, goods vehicles with a load capacity of less than 7 tonnes; Construction and earth-moving equipment

Class 2

Buses with a seating capacity of 30 or more passengers, heavy general purpose or specialized trucks, trailers and trailer-mounted containers; other self-propelling vehicles, Railroad cars, locomotives and equipment; Vessels, barges, tugs and similar water transportation equipment; Aircraft;Plant and machinery (including windmills, electric generators and distribution equipment) used in manufacturing or mining operations; specialized public utility plant and equipment; and machinery or other irrigation installations and equipment.

Class 3

Office furniture, fixtures, all equipment except for those listed in Class 2, Any asset not included in another Class

Class 4

Natural resource exploration and production rights, Expenditures incurred wholly and exclusively in respect of natural resource prospecting, exploration and development

Class 5

Buildings, structures, dams, water reservoirs, fences and similar works of a permanent nature used in agriculture, livestock farming or fishing farming;

Class 6

Buildings, structures and similar works of permanent nature other than those mentioned in Class 5

Class 7

Intangible assets other than those in Class 4

Class 8

Plant and machinery (including windmills, electric generators and distribution equipment) used in agriculture and electronic fiscal device purchased by a non Value Added Tax registered trader, Equipment used for prospecting and exploration of minerals or petroleum

2. Adding Depreciable Assets In The Pools Of Depreciable Assets

2.1 Pools of Depreciable Assets

In order to determine depreciation allowance, assets must be added to a pool of depreciable assets. Depreciation allowance is then determined for a pool of assets and not for an individual depreciable asset.

There are two types of pools of depreciable assets

(i) General Pools

This is a pool which comprises of all assets of the same class. This means all depreciable assets belonging to, say, class 1 are all pooled to one pool. In this case a class becomes a pool. However, this applies for all classes except class 7 assets and moveable tangible assets used by a person in conducting international transportation business [land, sea, or air] –transporting passengers, mail, livestock or other moveable tangible assets. These assets are pooled using specific pools.

(ii) Specific Pools

In this pooling strategy each individual asset forms a pool of its own different from assets of its class. An asset, say copy rights, plane, bus, vessel, etc, each form its own pool. Therefore, depreciation allowance will be calculated for eachcopy rights, plane, bus, vessel, etc. All the assets that do not follow general pooling strategy will fall under specific pooling.

2.2 Adding Depreciable Assets in the Pools of Depreciable Assets

Depreciation allowance is charged on depreciable assets which are found within the pool. Depreciable assets outside the pool cannot be charged depreciation allowances. Not every depreciable asset owned by the person qualifies for addition in the pool. There are conditions to fulfil. These are:

i] The depreciable asset must have been employed by the person wholly and exclusively in the production of business income of a person in the year of income.

ii] The person claiming the deduction must be beneficial owner and not the legal owner of the asset. The beneficial owner is the person who incurred the qualifying expenditure to or paid to acquire the depreciable asset.

3. Computation Of Depreciation Allowances

There are 3 types' depreciation allowance charges:

i] Initial Allowance

ii] Annual Allowance

iii] Terminal allowance

3.1 Initial Allowance

There are some depreciable assets which will be granted depreciation allowance immediately when added to the pool of depreciable assets. These depreciable assets are:

i] each item of plant or machinery which

ii] qualifies to be added in the person's Class 2, 3 or 8 pools of depreciable assets.

There are conditions however for an initial allowance to be granted to these assets. The assets above shall be:

i] used in manufacturing processes and fixed in a factory;

ii] used for providing services to tourists and fixed in a hotel

The amount of depreciation allowance is 50% of the net cost of the asset for assets belonging to class 2 or 3;. In the year in which initial allowance is charged, the asset granted this allowance will not be included in computation of annual allowance. In other words, the asset granted initial allowance will not be added in the pool of depreciable assets until after the preceding year.
The initial allowance granted to a person shall be available in two portions as follows -

i] the first portion shall be available in the year of income in which the asset is added to the person's pool of depreciable assets; and
ii] the remaining portion shall be available during the year of income following that in which the first portion is added.

3.2 Annual Depreciation Allowance

This is the annual charge of depreciation allowance from assets which are already in the pools of depreciable assets.

Depreciation Methods

Depreciation allowance shall be calculated using reducing balance method in the case of Class 1, 2 and 3 pools, and according to straight line method in the case of Class 4, 5, 6 and 7 pools.

Depreciation Formula

The depreciation formula put forward by the Act is the following:

Annual Depreciation Allowance = A x B x C/365

Where -**A** is the **depreciation basis** of the pool at the end of the year of income;
B is the **depreciation rate** applicable to the pool; and
C is the **number of days** in the person's year of income the asset was employed

Depreciation Basis – Reducing Balance Method

Depreciation basis of Class 1, 2, 3 or 8 pools of a person at the end of a year of income is computed as follows:

Depreciation Basis at the end of the year	=	Written Down Value at the start of the year	+	Additions to the Cost of the Asset	-	Incomings for the assets

Where by:
Written Down Value at the start of the year
= Closing Depreciation Basis for last year – Last Year Annual Depreciation
Additions = Cost of assets added in the pool during the year
Incomings = Proceeds from disposal of assets from the pool during the year

Depreciation basis in this case can only be reduced to zero but not below it. If it turns to be negative, then the pool is considered as written-off (non-existent).
Moreover, if the depreciation basis at the end of year is below TZS 1,000,000, the depreciation of the pool shall be equal to the depreciation basis at the end of that year [i.e. the figure below TZS 1,000,000].

Depreciation Basis – Straight Line

According to the Act, the depreciation basis of Class 4, 5, 6 or 7 pools of depreciable assets of a person at the end of a year of income shall be:

Depreciation Basis at the end of the year	=	Depreciation basis at the start of the year	+	Additions to the Cost of the Asset	-	Incomings for the assets

Depreciation basis for these classes can only be reduced to zero but not below it. That means, if the depreciation basis turns to be negative, then it shall instead be reported as zero.
Moreover, if the depreciation basis at the end of year is below TZS 1,000,000, the depreciation of the pool shall be equal to the depreciation basis at the end of that year [i.e. the figure below TZS 1,000,000].

On top of that the annual depreciation allowance granted to a person for a year of income with respect to a Class 4, 5, 6 or 7 pool of depreciable assets shall not exceed the Written Down Value of the pool at the end of the year of income.

Annual Depreciation of the pool ≤ Written Down Value of the pool at the end of the year of income.

Written Down Value for a pool of assets falling under class 4, 5, 6 or 7 is computed as follows:

Ending Written Down Value = Ending Depreciation Basis – Previous Years Accumulated Depreciation

You may notice differences in the Written Down Value formula for Class 4, 5, 6, or 7 pools vs Class 1, 2, 3 or 8 pools shown above.

3.3 Terminal allowances on Pool Disposal

Where the pool of assets is disposed of and the disposal proceeds are less than the tax written down value of the pool of assets, the disposer is entitled to claim the difference as addition allowance; or This allowance is granted in case of pool disposed physically but there is +ve figure of Opening + Addition- Disposal", this amount is granted as addition depreciation allowance based on residual concept of transactional tax treatment. If there is -ve figure of „Opening + Addition- Disposal", this amount shall be included in Profit or Gain u/s 8(2) (d).

Depreciation Rates

The depreciation rates applicable to each pool are as follows:

CLASS	RATE
1	37.5%
2	25%
3	12.5%
4	20%
5	20%
6	5%
7	1 ÷ useful life
8	100%

The useful life of the asset used in class 7 shall be rounded down to the nearest half year. For example a useful life of 5 years and 3 months shall be rounded down to 5 years, while a useful life of 7 years and 7 months shall be rounded down to 7.5 years.

Addition of Non-Commercial Vehicles

Commercial vehicle means a road vehicle designed to carry loads of more than half a tonne or more than thirteen passengers or a vehicle used in a transportation or vehicle rental business. Where a person acquires a non-commercial road vehicle whose value exceeds TZS 30,000,000, the amount of the expenditure allowed to be added to the pool in respect of the vehicle shall be only TZS 30,000,000. Any expenditure in excess of TZS 30,000,000 shall not be recognised.

Self-Examination Questions

Question 1

Mr. Makuti conducted a guest house business for the year ended 2019 with the following assets;

(i) A guest house building which cost Tshs. 40,000,000 by year 2018

(ii) 25 beds which cost Tshs. 2,000,000.

(iii) One ton Toyota pick-up that was imported form Dubai in December year 2019 for Tshs. 9,000,000.

(iv) One desktop computer which was purchased for Tshs. 4,000,000.

(v) 15 split unit air conditioners, costing Tshs. 6,000,000

(vi) 20 years leasehold of land as from January 2019 where the guest house building was constructed.

Required;

Compute the depreciation allowance to be granted to Mr. Makuti for year 2019. (Opening depreciation base for class 2 was 15,000,000)

Question 2

Maliba Limited is a company involved is a company involved in the manufacturing of shoes. The company is located in the Chirimba Industrial Area.

The following information is available in connection with the property and equipment used in Maliba Limited's business for the year ended 31st December, 2018. Tax written down Values (TWDV) as at 1st January, 2018.

	Tshs.
Factory building	850,060,000
Motor vehicles (saloon)	28,080,000
30 seats bus	6,750,250
Computers	2,500,000
Motor Lorries (for heavy work)	98,146,500
Accumulated depreciation for factory building	94,451,111

The following transactions took place during the year ended 31st December, 2018. Additions to property and equipment at cost:

		Tshs.
April	Machine (new)	86,000,500
July	Lorry (for light work)	45,265,000
August	Factory extension	12,465,000
September,	Computers (two desktops)	2,465,000

Included in the cost of the factory extension is the cost of an office amounting to Tshs. 5,620,500.

Disposals

April - Motor vehicle (sale proceeds) Tshs. 6,350,000.The vehicle had been purchased in January, 2017 for Tshs. 2,791,666.

Required:

(a) Prepare the capital allowances schedule for Maliba Limited for the year ended 31st December, 2018 and

(b) Compute the total allowances available to the company for the year.

Note: You should pay particular attention to the presentation of the schedule

Question 3

ABC Co. Ltd. Commenced a business of assembling computer hardware on 1st May 2018. The company acquired the following assets from XYZ which was winding up its business in the URT on 30th April 2018:

(i) A house which was used by the XYZ's director for Tshs. 15,000,000. This was converted by ABC Co. Ltd. into a factory building after incurring additional alterations cost of Tshs. 4,500,000.
(ii) Factory building was acquired for Tshs. 24,000,000. One fifth of this building houses the head office. The office was air conditioned with air conditioners worth Tshs. 2,000,000.
(iii) Factory plant and machinery worth Tshs. 180,000,000. The tax written down value (TWDV) of the machinery was Tshs. 60,000,000 in the vendor's books.
(iv) Two five-ton Lorries worth Tshs. 40,000,000 in total. Their total TWDV was Tshs. 32,000,000 and their total book value (BV) was Tshs. 28,000,000.
(v) A saloon car costing Tshs 33,000,000. This car had a nil BV and TWDV in the books of the vending company. ABC Co. Ltd. used the car purely for business purposes.
(vi) Office furniture was purchased for Tshs. 4,200,000. This asset had a TWDV of Tshs. 1,800,000/= and accumulated depreciation of Tshs. 400,000.
(vii) Office stationery and some operational guides were also purchased for Tshs. 1,900,000/=

After the commencement of the business, the following transactions took place:

i) One of the Lorries was qutted by fire Tshs. 8,000,000 as insurance compensation was received from National Insurance Corporation for the loss.
ii) On 1st November 2018 an eight-ton trailer was purchased for Tshs. 38,000,000.
iii) BBA sold to ABC Co. Ltd. a godown building constructed for Tshs. 15,000,000 at Tshs. 175,000,000. It was used for storage of ABC Co. Ltd. finished products from 1st January 2019.
iv) The remaining lorry was exchanged for a new one on 1st March 2019. ABC Ltd. had to pay an additional Tshs. 10,000,000 for the new lorry, the total cost of which was Tshs. 24,000,000.

Required: Compute depreciation allowances to be granted to ABC Co. Ltd. for the year of income 2019 under the Income Tax Act, Cap 332.

Question 4

a. Define the term 'depreciable assets' as per the Income Tax Act, Cap 332.

b. Clearly provide at least five (5) conditions to be fulfilled by a person before being granted depreciation allowance as per the Income Tax Act, Cap 332.

c. OKWI Co. Ltd was incorporated in the United Republic of Tanzania in May 2015. It started business in June 2015, the accounting period of the company ends on 31st December.

The company's activities include; tour operator, travel agent and hotelier. In order to expand its business, the company entered into an agreement with Entebe Air to lease one of its aircrafts. The lease period was 96 months commencing on 1st July 2015.

The lease value was TZS.4.8 billion where as the lease agreement conditions to be borne by the lessee included repair and maintenance, and monthly rental charge of TZS.46 million. The lessee was not allowed to re-release the aircraft, and the lease agreement was renewable.

Other information from OKWI Co. Ltd include expenditure incurred during the year as maintenance cost of TZS.10,850,000.

Required:

Calculate depreciation allowance for the year 2015 as per the provisions of the Income Tax Act, Cap 332.

Answer to Self-Examination Questions

Answer to SEQ 1

Depreciation schedule

	Class 1	**Class 2**	**Class 3**	**Class 6**	**Total depreciation allowances**
Rate	37.50%	25%	12.50%	5%	
TWDV at start	-	15,000 ,000	-	-	
G. House				40,000, 000	
25 Beds			2,000,000		
Pick up	9,000,000				
Computer	4,000,000				
15 air Conditions			6,000,000		
Depreciation base	13,000,000	15,000,000	8,000,000	40,000,000	
D. Allowance	4,875,000	3,750,000	1,000,000	2,000,000	11,625,000
TWDV at end	8,125,000	11,250,000	7,000,000	38,000,000	

- Item (vi) is not depreciable asset.
- Class 6 workings A x B x C/365 Days = 40,000,000 x 5% 365/365 = 2,000,000.

Answer to SEQ 2

Depreciation schedule

	Classes			Total depreciation allowances
	I	II	VI	
TWDV at start				
Factory building			850,060,000	
Motor vehicle (Saloon)	28,080,000			
30 seats Bus		6,750,250		
Computers	2,500,000			
Motor lorries		98,146,500		
TWDV 1/1/2007	30,580,000	104,896,750	850,060,000	
Additions				

Lorry		45,265,000		
Computers	2,465,000			
Factory extension			12,465,000	
	33,045,000	150,161,750	862,525,000	
Realisation				
Motor vehicles	(6,350,000)			
Depreciation basis	26,695,000	150,161,750	862,525,000	
Rate	37.5%	25.0%	5.0%	
Annual Depreciation allowance	(10,010,625)	(37,540,438)	(47,486,808)	95,037,870
TWDV 31/12/2007	16,684,375	112,621,313	815,038,192	
1st portion of initial allowances	1/2*43,000,250			21,500,125
				116,537,995

Note 1:
Machines are used in manufacturing. They enjoy initial allowance in first year put into use and 50% of cost is added in the pool under class 2 after 12 months. The 1st portion of the initial allowance is claimed in the first year put into use , the 2nd portion shall be claimed 12 months after the machine is pooled.

Note 2:
Depreciation for class 6.

On 1/1/2017 WDV for building	850,060,000	
Add: Acc Depr.	94,451,111	
Depreciation Basis	944,511,111	
Depreciation allowance = 944,511,111 x 5% x 365/365 =		47,225,555 9
Depreciation for addition = 12,465,000 x 5% x 153/365 =		261,252.7
Total depreciation allowance		47,486,807.70

Answer to SEQ 3
Computation of Depreciation Allowance

CLASS	I	II	III	VI	Total depreciation allowances
RATE-A	37.5%	25%	12.5%	5%	
	Tshs'000'	Tshs'000'	Tshs'000'	Tshs'000'	Tshs'000'
House				19,500	

Factory building				24,000	
Air conditioners			2,000		
2 lorries five tons	40,000				
Saloon Car(at restricted cost)	30,000				
Office furniture			4,200		
Office stationary (revenue expenses)					
Eight-ton trailer		38,000			
Exchanged lorry	24,000				
Godown				175,000	
Total	94,000	38,000	6,200	218,500	
Less: Incomings					
One lorry caught by fire	(8,000)				
Exchanged lorry	(14,000)				
Depreciation base	72,000	38,000	6,200	218,500	
Annual depreciation allowance	27,000	9,500	775	10,925	
Initial Allowance-Plant and Machinery (1/2 ×50% of 180,00,000		45,000			
TOTAL ALLOWANCES	27,000	54,500	775	10,925	93,200
TWDV 31st December 2019	35,625	28,500*	5,425	207,575	

*(38,000-9,500)

Answer to SEQ 4

(a) As per S.3 of the ITA 2004, **Depreciable assets** means an asset employed wholly and exclusively in the production of income from a business, and which is likely to loose value because of wear and tear, obsolescence or the passing of time **but excludes** goodwill, an interest in land, a membership interest in an entity and trading stock. Examples of depreciable assets employed in the business may include office furniture, office computer, office building, fixtures and fittings installed in the office etc.

(b) As per section 17 of the Income Tax Act 2004 as conditions to be fulfilled by a person before being granted depreciation allowance are:

- The items must be depreciable assets
- Must be owned by the person generating his income
- Must be wholly and exclusively employed in the production of the person's income from the business.
- Must be employed during the year of income in which it relates
- It must be a domestic assets i.e. situated in United Republic of Tanzania.

(c) **Name of the taxpayer:** OKWI Co. Ltd.
Residential status: Resident Corporation
Year of income: 2015
Computation of Depreciation allowance to be granted for the year 2015 as per the third schedule of the ITA 2004;
Depreciable item

Air craft lease (Class vii)	4,800,000,000
Duration of the lease	96 months
Usage during the year 2015	184 days

Depreciation Allowance

Formula = AxBxC/365

Where

A = is the depreciation basis of the pool at the end of the year of income
= 4,800,000,000

B = is the depreciation rate applicable to the pool (i.e $^1/_n$ = $^1/_8$)

C = the number of days in the person's year of income = 184 days
Therefore,
Depreciation allowance = 4,800,000,000 x 1/8 x 184/365.
Depreciation allowance = Tshs.302,465,753.42.

SECTION D

COMPUTATION OF TAXABLE INCOME

D1

STUDY GUIDE D1: EMPLOYMENT INCOME

Get Through Intro

Total Income includes income from employment, businesses and investment. Employment income considers all income from an employment. Specifically, this Study Guide elucidates items which are included in computation of taxable income from employment and those items which are excluded when computing an individual's employment income. Further, it deals with valuation of employment benefits in kind.

This Study Guide will enable you to establish the correct taxable employment income. Knowledge of determining employment income is essential in understanding how employees are taxed. It is also important to know this computation to avoid breaking tax laws either by failing to collect employment taxes when they are supposed to be collected or burdening employees with incorrect employment taxes. Sections from Income Tax Act ,Cap 332 are being referred to throughout this Study Guide.

Learning Outcomes

(a) Identify items included in calculation of chargeable income from employment.
(b) Identify items excluded in calculation of chargeable income from employment.
(c) Identify the allowable deductions.
(d) Establish income from employment.

Identify items included in calculation of chargeable income from employment and identify items excluded in calculation of chargeable income from employment.
[Learning outcome a and b]

1. Items Included In Calculation Of Chargeable Income From Employment

1.1 Definitions

Employment includes in particular:

- a position of an individual in the employment of another person;
- a position of an individual as manager of an entity other than as partner of a partnership;
- a position of an individual entitling the individual to a periodic remuneration in respect of services performed; or
- a public office held by an individual, and includes past, present and prospective employment

Section 3

'Employee' means an individual who is the subject of an employment conducted by an employer;
Section 3
'Employer' means a person who conducts, has conducted or has the prospect of conducting the employment of an individual.
Section 3

Normally, employment is demonstrated by presence of **contract of service** or employment. The **contract of service** exists when an employer dictates what an employee should do and how, in return for period payments.

In a case of Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance [1968] 2 QB 497 it was decided that contract of service might exist when:

(i) an employee agrees that, in consideration of a wage or other remuneration, he will provide his own work and skill in the performance of some service for his master.
(ii) He agrees, expressly or impliedly, that in the performance of that service he will be subject to the other's control in a sufficient degree to make that other master.
(iii) The other provisions of the contract are consistent with its being a contract of service.

Control was associated with power of the employer to decide things to be done, the way in which it shall be done, the means to be employed in doing it, the time when and the place where it shall be done.

However, in the same case it was suggested that **contract for service** (sole trading or businesses) occurs when a contractor hires his own employees, provides and maintains his own tools or equipment; the contractor is paid by reference to the volume of work done; has invested in the enterprise and bore the financial risk; have the opportunities of profit or the risk of loss; and the relationship is not permanent.

Likewise, in McManus v Griffiths (1997) 70 TC 218 case the judge suggested in deciding whether a person was employed (**contract of service or self-employed - contract for** service) we should consider the substance of the contractual arrangements rather than their form or the parties' labels (incorporated companies).

In F S Consulting Ltd v McCaul (2002) case it was decided that the owner of F S Consulting Ltd, Mr Frank Simpson earned income under contract of service not contract for service. Mr Simpson was a computer consultant and the sole director and shareholder of F S Consulting Ltd. During the relevant time of the contract Mr Simpson supplied his services to the F S Consulting Ltd who supplied them to an agency called Topper Recruitment Limited (Topper) who supplied them to Better Investments Plc (Better). It was disputed that Mr Simpson was **an employee** of Better Investment Plc. The judge asserted that:

- Mr Simpson did agree, in consideration of remuneration, to provide his own work and skill to Better and it was also part of the arrangements that the standard working week was 37.5 hours. Any absence of Mr Simpson had to be agreed and approved in advance by Better (although in fact there were no difficulties)
- Mr Simpson was a man of skill and experience and so it would not be expected that Better would tell him how to do his work; however, Mr Simpson was part of a team made up mainly of employees of Better and of which the project manager was an employee of Better. The project manager controlled what was to be done and when it was to be done although he left it to Mr Simpson to decide how it should be done. Also, the contract between the appellant and Topper provided that Mr Simpson had to take all necessary instructions from Better and comply with Better's rules, regulations and procedures
- In the performance of his work Mr Simpson was also subject to Better's control to the extent that the contract between the Appellant and Topper provided that it could be terminated immediately if Better terminated its agreement with Topper because of the incompetence, unsuitability or unprofessional conduct of Mr Simpson
- Mr Simpson did not hire his own employees; the members of his team were mainly permanent employees of Better and one other consultant who had entered into his own contract with Better
- Mr Simpson did not provide and maintain his own tools and equipment; he used the mainframe computer and other equipment provided by Better
- Mr Simpson was not paid by reference to the volume of work done but by reference to the number of hours he worked
- Mr Simpson did not invest in any enterprise and he did not bear any financial risk; he had no opportunity of profit and no risk of loss. All his invoices were paid
- The relationship between Mr Simpson and Better had some element of permanency as it lasted for two and a half years from December 1998 to June 2001
- While working for Better Mr Simpson only provided work for Better and for no other client. Before working for Better he worked for two other clients and since leaving Better he has worked for one other client but has never worked for more than one client at a time
- Mr Simpson was integrated into the structure of Better to the extent that he worked closely with its employees; also the project manager was an employee.

Therefore, Mr Simpson was an employee of Better.

In calculating an individual's gains or profits from an employment for a year of income the following payments made to or on behalf of the individual by the employer or an associate of the employer during that year of income shall be included:

1.2 Secondary employment.

There are employees who have more than one employment e.g. persons with several directorships or persons with part-time employments. The employee having more than one employment shall select (at the employee's choice) one of those employments to be the employee's primary employment and the remaining employment shall be secondary employment. Secondary employers should apply similar process as primary employer in determining monthly pay and deduction of tax. However, secondary employers do not use progressive rates and the income tax tables to calculate the amount of tax to be withheld from monthly pay. Secondary employers must withhold tax at the highest individual rate (currently 30%) from the full amount of monthly pay

1.3 Employment income items

Income in connection with employment income (contract of service) means:

(i) Wages, salary, payment in lieu of leave, fees, commissions, bonuses, gratuity or any subsistence, travelling, entertainment or other allowance received in respect of the employment or services rendered;

(ii) Reimbursement by an employer of personal expenditure by the employee or an associate of an employee;

(iii) Payments for the employee's agreement to any conditions of the employment;

(iv) Retirement contributions and retirement payments paid by an employer on behalf of employees

(v) Payment for redundancy or loss or termination of employment relating to the year of payment;

(vi) Other payments made in respect of the employment including benefits in kind (Section 7(2)).

Example

Robots and Assembler Design makers employed Ms. Rachel Makona as the Company Accountant with effect from 1 January 2017. By the time the company submitted a statement of employment income for year 2018, the following information was revealed to her as her monthly emoluments:

	TZS
Basic monthly salary	600,000
Transport allowance monthly	250,000
Lunch allowance monthly	150,000
Medical allowance monthly	100,000

The employer housed her for free. The market value of rental at that area was TZS 400,000 per month and the expenditure claimed by the company for that premises was TZS 150,000. The contribution made monthly by the employee was TZS 50,000 as rent. Beside the emoluments stated above, the employee had the following benefits:

(i) Self-driven car for private use, which is 3000 cc, brand new. The company claims expenditure of car maintenance.

(ii) Loan advances of Tshs3,000,000 payable in 15 monthly instalments and free of interest. Statutory rate was 10% per annum.

(iii) Other benefits included electricity TZS 30,000 and water TZS 25,000 per month.

The employer was contributing 15% of basic salary to the approved retirement fund, while the employee contributed 5%.

Though her employment services were terminated on 31 December 2018, the company paid her Tshs30,000,000 as termination benefits (compensation for lost employment).

Other income she received in 2018 was TZS 300,000 interest from CRDB Bank (a resident person), TZS1,500,000 – lease amount from Milk Shake Company for the building she leased to the company since 2008.

Required:

Identify items included in chargeable employment income for the year 2018.

Answer

With exception of interest from CRDB Bank and rent from Milk shake company all other is employment income.

1.4 Taxation of benefits in kind as employment income

Quantification of employment benefits in kind are dealt with in Section 27 of the Income Tax Act 2004. Generally, benefits in kind are valued on market values of the benefits, but with exception of car benefits, beneficial loans and house benefits. These three benefits have specific approaches concerning their valuations. Therefore, this Study Guide explains these approaches in detail.

1. **Private uses of motor car**

When an employee uses an employer's car for official purposes, it results in no taxable income. However, there is taxable benefit when the employee uses the car for private purposes, provided the employer claims maintenance and ownership allowances of the car when computing his/her taxable income (Section 7(3) (e)). In that case, the car benefit is the value given as per the table below.

As you can see, the value of car benefit depends on engine size of cars and age of the car; the age is counted from the first registration of the car in the United Republic of Tanzania.

Engine Size of Vehicle	Quantity of payment per annum	
	Vehicle less than 5 years old	**Vehicle more than 5 years old**
Not exceeding 1000cc	Tshs250,000	Tshs125,000
Above 1000cc but not exceeding 2000cc	Tshs500,000	Tshs250,000
Above 2000cc but not exceeding 3000cc	Tshs1,000,000	Tshs500,000
Above 3000cc	Tshs1,5000,000	Tshs750,000

Required:
Establish the taxable car benefit in kind of Ms. Rachel Makona for the year 2018**.**

Answer
From the information available in the question, the car is brand new and operates at 3,000 cc. Therefore, from the table above, the annual car benefit is calculated as Tshs1,000,000.

2. Loan benefit

When an employer provides staff loans at lower interest rates compared to statutory rates or interest free loans; recipient employees enjoy taxable income. The taxable income is the whole of the forgone interest in the case of interest free loans and when the lower interest rate is offered the benefit would be calculated based on the relinquished part of interest rate.

However, no taxable benefit is derived when the loan made by an employer to an employee is for less than 12 months **and** the aggregate amount of the loan and any similar loans outstanding at any time during the previous 12 months do not exceed 3 times the month's basic salary (Section 27(1) (b)).

'Statutory rate' in relation to a calendar year means the prevailing discount rate determined by the Bank of Tanzania;
Section 3
In short taxation of beneficial interest one needs to know the following important aspects

- Check whether the loan made by an employer to an employee is for less than 12 months **and t**he aggregate amount of the loan and any similar loans outstanding at any time during the previous 12 months do not exceed 3 times the month's basic salary. If yes, no taxable benefit arises from the loans given. Otherwise, go to the next steps.
- The loans are given to employees because they are just employees, otherwise loans provided in normal course of business at market terms are not employee beneficial loans.
- The benefit bases on the forgone interest rate which can be statutory rate when the loans concerned are interest free, otherwise the benefit is statutory rate less interest paid by employees.
- Interest = Outstanding amount x (statutory rate – interest rate paid) x time/12

Refer to the information of Test Yourself 1 of Robots and Assembler Design makers.
Required:
Calculate the loan benefit of Ms. Rachel Makona for the year 2018**.**
Solution
The loan made by the employer to the employee is for more than 12 months (in this case 15 months term) also the aggregate amount of the loan and any similar loans outstanding at any time during the previous 12 months exceed 3 times the month's basic salary (Tshs3,000,000 is greater than 3 times basic salary i.e. Tshs600,000). So the beneficial loan is taxable.
As the loan balance did not change, the formula of simple interest can be used to determine the forgone interest.
So Interest = Principle x time/12 x saved interest rate = Tshs3,000,000 x 12/12 x 10%= Tshs300,000

3. Residential premises benefit

There is taxable employment benefit when an employee lives in a subsidized house and the employee claims maintenance and ownership allowances in his/ her tax returns (Section 27(1)(c)). This valuation of taxable house benefit in kind includes any furniture or other contents provided by an employer for residential occupation by an employee during a year of income. Actually, the taxable benefit is the lower of (i) and (ii) – given below after being reduced by any rent paid for the occupation by the employee.

(a) the market value rental of the part of the premises occupied by the employee for the period occupied during the year of income; and

(b) the greater of:

(i) 15% of the employee's total income for the year of income, calculated without accounting for the provision of the premises and, where the premises are occupied for only part of the year of income, apportioned as appropriate;

(ii) and expenditure claimed as a deduction by the employer in respect of the premises for the period of occupation by the employee during the year of income;

The total income of a person is the sum of the person's chargeable income for the year of income from each employment, business and investment less any reduction allowed for the year of income under Section 61 relating to retirement contributions to approved retirement funds

Section 5 (1)
Example
Hewit Ltd employed Ms Tracy Jones as the Company Accountant with effect from 1 January 2019. By the time the company submitted a statement of employment income for year 2010, the following information was revealed to her as her monthly emoluments:
Basic monthly salary Tshs 600,000
Transport allowance monthly Tshs 250,000
Lunch allowance monthly Tshs150,000
Medical allowance monthly Tshs100,000
The employer housed her freely. The market value of rental at that area was Tshs400,000 per month and the expenditure claimed by the company for that premise was Tshs150,000. The contribution made monthly by the employee was Tshs50,000 as rent. Beside the emoluments stated above, the employee had the following benefits.

(i) Self-driven car for private use, which is 3000 cc, brand new. The company claims expenditure of car maintenance.
(ii) Loan advances of Tshs3,000,000 payable after 15 monthly and free of interest. Statutory rate was 10% per annum.
(iii) Business income of Tshs1,000,000 and investment income of Tshs500,000
(iv) Other benefits included electricity Tshs30,000 and water Tshs25,000 per month.

Workings
Establishment of total income before house benefit in kind

Items	Tshs	Tshs
Basic salary	600,000 x12	7,200,000
Transport allowance	250,000 x12	3,000,000
Lunch allowance	150,000 x 12	1,800,000
Medical allowance	100,000 x 12	1,200,000
Car benefit as above	1,000,000	1,000,000
Loan benefit as above	300,000	300,000
Electricity	30,000 x12	360,000
Water	25,000 x12	300,000
Employment income		12,760,000
Add: Business income		1,000,000
Add: Investment income		500,000
Total income		**14,260,000**

House benefit is the lower of:

Tshs2,139,000
(ii) Employer's claim
Tshs1,800,000.
This is reduced by monthly contribution made during the year of Tshs600,000 (Tshs50,000 x12). So the house benefit without deduction of monthly contribution was Tshs2,139,000. It is the lower of Tshs4,800,000 and Tshs2,139,000. **The ultimate house benefit was Tshs1,539,000.**

1.5 Redundancy, or loss or termination benefit paid in arrears

In accordance with Section 7(4), while calculating an individual's gains or profit from payment for redundancy or loss or termination of employment, any payment received in respect of a year of income which expired earlier than five years prior to the year of income in which it was received, or which the employment or services ceased, if earlier such payment shall, for the purposes of calculation of the tax payable thereon, should be allocated in following manner:

- the payments should be **allocated equally** between the years of income in which it is received or,
- if the employment or services ceased in an earlier year between such earlier year of income and **the five years** immediately **preceding** such earlier year of income.

Actually, each such portion, allocated to any such year of income, is deemed to be income of that year of income in addition to any other income in that period (Section 7(4)).

In short the allocation process of redundancy, or loss or termination benefit paid in arrears can be summarized into four major steps:

1. Decide the earlier period between the year of receipt, or which the employment (services) ceased.
2. Total **redundancy, or loss or termination benefits** relating to periods **earlier** than five years prior to **the earlier of** the year of receipt, or which the employment/ services ceased.
3. Divide the total above by 6, allocate the amount to **5 years** immediately preceding such earlier year of income in step a above and in that **earlier period.**

Example

Mr. Jaffer was employed by Kahama Mining Corporation Ltd since 2000. His monthly salary was Tshs960,000 per month with effect from 1st. Mr. Jaffer was also provided with free residential house accommodation by the employer and the resulting benefit was correctly determined to be Tshs200,000 per month; and employer claimed ownership allowances.

However, he was terminated on 31 December 2010 and paid a lump sum compensation of Tshs18,560,000 on termination of his contract of employment on September 2013. The amount was earned equally throughout ten years of employment.

Required:

You are required to establish his taxable income and state which year it will be taxable

Solution

(a) The earlier period between the year of receipt i.e. 2013, or which the employment or services ceased i.e. 2010, is 2010.

(b) Total redundancy, or loss or termination benefits relating to periods earlier than five years prior to 2010, i.e.
before 2005 i.e. 2000-2004 is equal to Tshs1,856,000 x 5 = Tshs9,280,000.

(c) Divide the total above by 6, then allocate the amount to 5 years immediately preceding 2010 in step 'a' above and in 2010. That is, allocate Tshs1,546,667 to 2010, 2011, 2012, 2013, 2014, and 2015. The amount allocated will be taxed in the period allocated.

(d) Finally, the remaining balance (from 2005 to 2010) of termination benefit will be taxed on cash basis on the date of receipt i.e. September 2013.

1.6 Taxation of employment termination benefits

Likewise taxation of employment termination benefits has three special treatments.

Fixed employment contract

First, when a fixed employment contract is terminated before its expiration and the affected employee gets termination benefits; taxable termination benefits should not exceed the amount which would have been received in respect of the unexpired period (Section 7(5) (a)). Also this amount is assumed to have accrued evenly in such unexpired period.

Employment contract (which provides for compensation on termination) having unspecified term

Second, when an employment contract which has unspecified term and provides for compensation on its termination, the compensation thereon is deemed to have accrued in the period immediately following such termination at a rate equal to the rate per annum of the gains or profits from such contract received immediately prior to such termination (section 7(5)(b)).

Employment contract (which does not provide for compensation on termination) for an unspecified term

Finally, when an employment contract is for an unspecified term and does not provide for compensation on its termination thereof, any compensation paid on the termination thereof is deemed to have accrued in the period immediately following such termination at a rate equal to the rate per annum of the gains or profits from such contract received immediately prior to such termination, but the amount so included in gains or profits must not exceed the amount of three years' remuneration at such rate (section 7(5)(c)).

Example

Mr. Jaffer was employed by Kahama Mining Corporation Ltd since 2010. His monthly salary was Tshs 960,000

per month gross with effect from 1st. Mr. Jaffer was also provided with free residential house accommodation by the employer and the resulting benefit from the house benefits was correctly determined to be Tshs 200,000 per month and employer claimed ownership allowances. However, he was terminated on 31 December 2015 and paid a lump sum compensation of Tshs 18,560,000 on termination of his contract of employment.

You are required to establish his taxable termination benefit and stated when i.e. year it will be taxable if:

(a) The contract of employment was for ten years.

(b) The contract of employment was for unspecified term and provides for termination benefits

(c) The contract of employment was for unspecified term and does not provide for termination benefits.

Answer:

(i) Fixed employment contract

When the contract is for specified term the taxable benefits of termination benefits should not exceed the amount that could have been received in absence of termination of the contract in an unexpired period. In this case the amount is (Tshs 960,000 + Tshs 200,000) x 5 years. X12 months= Tshs 69,600,000.

So as the amount received is lower than Tshs 69,600,000 the whole amount will be taxable termination benefits. However, it should be allocated equally in the five remaining years from 2016 to 2020. So each year gets Tshs 3,712,000 from Tshs 18,560,000/5.

(ii) Employment contract (which provides for compensation on termination) having unspecified term

In case of unspecific employment contract but provides for termination compensation benefit, the taxable benefit should not exceed annual employment income immediately before termination. As the termination happened on 31st December 2015, the annual employment income should base on this year. So the taxable amount should not exceed Tshs 13,920,000 ((960,000+200,000) x 12). Consequently, the taxable termination benefits were Tshs 13,920,000 and deemed to have accrued in the next year 2016.

(iii) Employment contract (which does not provide for compensation on termination) for an unspecified term

Finally, when the contract is for unspecified term and does not provide for termination benefits, in case termination benefits is received, the maximum taxable amount should be 3 times the annual employment income immediately before the .termination. In this case it should not exceed Tshs 13,920,000 x 3 = Tshs 41,760,000. So as this amount is higher than Tshs 18,560,000, the amount received should be taxed in 2016.

2. Items Excluded In Calculation Of Chargeable Income From Employment

According to Section 7(3) of the Income Tax Act 2004, the following income earned by employees from their employments is not taxable:

(a) exempt amounts and final withholding payments; on-premises cafeteria services that are available on a non-discriminatory basis;

(b) medical services, payment for medical services, and payments for insurance for medical services to the extent that the services or payments are;

(i) available with respect to medical treatment of the individual, spouse of the individual and up to four of their children; and

(ii) made available by the employer (and any associate of the employer conducting a similar or related business) on a non-discriminatory basis;

(c) any subsistence, travelling, entertainment or other allowance that represents solely the reimbursement to the recipient of any amount expended by him wholly and exclusively in the production of his income from his employment or services rendered;

(d) benefits derived from the use of motor vehicle where the employer does not claim any deduction or relief in relation to the ownership, maintenance or operation of the vehicle;

(e) benefit derived from the use of residential premises by an employee of the Government or any institution whose budget is fully or substantially out of Government budget subvention;

(f) payment providing passage of the individual, spouse of the individual and up to four of their children to or from a place of employment which correspond to the actual travelling cost where the individual is domiciled more than 20 miles from the place of employment and is recruited or engaged for employment solely in the service of the employer at the place of employment;

(g) retirement contributions and retirement payments exempted under the Public Service Retirement Benefits Act;

(h) payment that it is unreasonable or administratively impracticable for the employer to account for or to allocate to their recipients and;

(i) allowance payable to an employee who offers intramural private services to patients in a public hospital;

(j) housing allowance, transport allowance, responsibility allowance, extra duty allowance, overtime allowance, hardship allowance and honoraria payable to an employee or the Government or its institution whose budget is fully or substantially paid out of Government budget subvention.

In addition, board members sitting allowance is exempted because it is deemed as reimbursement of members' time (Income Tax Act 2004, Practice Note No. 11/2004) as well as gifts, tips, prizes, incentives and voluntary payments made to an employee **with no reference** to the employment as acknowledging faithfulness, and consistency and readiness of the employee (Income Tax Act 2004, Practice Note No. 11/2004; Ball v Johnson 1971; Cooper v Blakiston HL 1908, Calvet v Wainwright (1947).

Exempt income

Exempt income items are normally given in the schedules reproduced below to assist you in understanding exempt employment income, please take time to familiarize yourself with this schedule, particularly paying attention to employment income.

Second schedule and section 52 and 86

The following amounts are exempt from income tax:

(a) amounts derived by the President of the United Republic or the President of the Revolutionary Government of Zanzibar from salary, duty allowance and entertainment allowance paid or payable to the President from public funds in respect of or by virtue of the office as President;

(b) amounts derived by the Government (including Executive Agency established under the Executive Agencies Act, 1997) or any local authority of the United Republic or by the Revolutionary Government of Zanzibar or any local authority of Zanzibar except amounts derived from business activities that are unrelated to the functions of government;

(c) amounts derived by any person entitled to privileges under the Diplomatic and Consular Immunities and Privileges Act to the extent provided in that Act or in regulations made under that Act;

(d) amounts derived by an individual from employment in the public service of the government of a foreign country provided:
  (i) the individual is a resident person solely by reason of performing the employment or is a non-resident person; and
  (ii) the amounts are payable from the public funds of the country;

(e) foreign source amounts delivered by:
  (i) an individual who is not a citizen of the United Republic and who is referred to in paragraph (d); or a spouse or child of an individual referred to in subparagraph
  (ii) where the spouse is resident in the United Republic solely by reason of accompanying the individual on the employment;

(f) Amounts derived by:
  (i) the East Africa Development Bank;
  (ii) the Price Stabilization and Agricultural Inputs Trust;
  (iii) the Investor Compensation Fund under the Capital Markets Regulatory Authority; and
  (iv) The Bank of Tanzania.
  (v) Dar es salaam Stock of Exchange
  (vi) African Development Bank from the sale of bonds and securities in the capital

(g) amounts derived during a year of income by a primary cooperative society:
  (i) registered under the Co-operative Societies Act;
  (ii) solely engaged in activities as a primary cooperative in one of the following fields:
    (aa)agricultural activities, including activities related to marketing and distribution;
    (bb)construction of houses for members of the cooperative;
    (cc)distribution trade for the benefit of the members of the cooperative;
    (dd)savings and credit society; and
  (iii) whose turnover for the year of income does not exceed Tshs.50,000,000;

(h) pensions or gratuities granted in respect of wounds or disabilities caused in war and suffered by the recipients of such pensions or gratuities;

(i) a scholarship or education grant payable in respect of tuition or fees for full-time instruction at an educational institution;

(j) amounts derived by way of alimony, maintenance or child support under a judicial order or written agreement;

(k) amounts derived by way of gift, bequest or inheritance, except as required to be included in calculating income under Sections 7(2), 8(2) or 9(2)

(l) amounts derived by way of foreign living allowance by any officer of the Government that are paid from public funds and in respect of performance of the office overseas;

(m) Income derived from gaming by a gaming lincensee who has paid gaming tax under Gaming Act;

(n) income derived from investment or business conducted within the Export Processing Zone, and Special Economic Zone during initial period of ten years;

(o) income derived from investments exempted under any written laws for the time being in force in Tanzania Zanzibar;

(p) rental charges on aircraft lease paid to a non-resident by a person engaged in air transport business; amounts derived by a crop fund established by farmers under a registered farmers cooperative society, union or association for financing crop procurement from its members;

(q) the fidelity fund established under the Capital Markets and Securities Act

(r) Amounts derived from gains on realization of asset by a unit holder on redemption of a unit by a unit trust.

(s) payment of withholding' tax on dividend arising from investment in the Export Processing Zone and Special Economic Zone during initial period often years; and

(t) payments of withholding tax on rent payable by an investor licensed under the Export Processing Zone and Special Economic Zone during initial period of ten years, provided that the rent is payable to an investor licensed under the Economic Processing Zones or the Special Economic Zones."

(u) Distributions of a resident trust or unit trust shall be exempt in the hands of the trust's beneficiaries (Section 52)Rent which does not exceed Tshs500,000, received by a resident individual (the "landlord") in respect of residential premises situated in the United Republic that are leased by another individual as the residence of that other individual and the rent is not received by the landlord in conducting a business (Section 86(4)).

Final withholding payments

These are payments which are taxed only at the source by withholding the tax by the payers of the payments.

So these payments are normally excluded in computation of income from employment, investment or businesses. The following payments are final withholding payments as per section 86.-(1):

- Dividends paid by a resident corporation or non-resident corporation to a resident individual resulting from investment activities.
- Interest paid by financial institution to a **resident individual** where the interest is paid with respect to a deposit held with the institution, other than interest received by the individual in conducting a business; or foreign source interest paid to non-resident individual.
- Rent paid to a resident individual under a lease of land or a building and associated fittings and fixtures, other than rent received by an individual in conducting a business; or foreign source rent paid to non- resident individual.
- Service fees paid to a resident person who is conducting a mining business in respect of management or technical services provided wholly and exclusively for the business by another resident persons and money transfer commission to a resident money transfer agent.
- Payments made to non-resident persons other than through a domestic permanent establishment of the person) that are subject to withholding taxes.
- Interest paid to a unit trust.
- Dividends distributed by a resident corporation not in a virtue of its ownership of redeemable shares (section 54(1)).

Identify the allowable deductions and establish income from employment.

[Learning outcome c and d]

3. Allowable Deductions

Apart from some exemptions, the Act has provided two deductions when computing income from employment. These are:-

Voluntary contribution of any amount to education establishment made under Section 12 of the Education Fund Act by an employee is deductible expenses in determining his or her taxable employment income (Section 16(3)).

(ii) Retirement contributions to approved retirement fund

In addition, employees can deduct pension contributions made by themselves or their employers on employees' behalf (or for the employees' spouses) to approved pensions. Actually the law allows deduction of pension contribution **made by the individual; *or* an employer of the individual** to approved pension funds **where the contribution is included** in calculating the individual's income from the employment (Section 61(1)). However, the reduction claimed by an individual for any year of income should be **the lower of the actual contribution or the statutory amount required** (Section 61(2)).

The statutory amount is TZS 2,400,000 *if Actual Contributions do not exceed TZS 2,400,000 or w*here actual contribution paid to the retirement fund exceeds TZS 2,400,000, the statutory amount will be the maximum obligatory contribution required by the fund (which is 20% of remunerations).

Definitions

- **'Retirement contribution'** means a payment made to a retirement fund for the provision or future provision of retirement payments.

Section 3

- '**Retirement fund'** means any entity established and maintained solely for the purposes of accepting and investing retirement contributions in order to provide retirement payments to individuals who are beneficiaries of the entity.

Section 3

- '**Statutory contribution'** is when the total contribution to an approved retirement fund required by statute in relation to an employee is in excess of Tshs2,400,000 per year, the amount of that obligation or in any other case, Tshs2, 400,000.

Income Tax Regulation 10

- '**Approved retirement fund'** means a resident retirement fund having a ruling under Section 131.

Section 3

4. Chargeable Income From Employment

'Chargeable business income' of resident person, includes all his or her income for the year of income irrespective of the source of the income, while **chargeable income** of non-resident persons income only to the extent that the income has a source in the United Republic. Payments attributable to employment exercised or a forbearance from exercising employment have a source in the United Republic where –

i) The employment or the forbearance is exercised in the United Republic, regardless of the place of payment. Exercising in this sense means the actual carrying out of the employment activities which may include physical presence of the employee at the place of employment.

ii) The payer for the exercising of the employment or the forbearance is the Government of the United Republic, including the Revolutionary Government of Zanzibar (SMZ) or any Tanzania local authority.

The employment income is generally computed on cash basis unless specifically required by tax laws.

The statement below can help us when computing taxable employment income.

Computation of chargeable employment income

Items	Tshs
Salary Bonus Transport Meals	XX
House benefit	XX XX XX XX XX
Loans	
Less:	(XX) (XX) XXX
Contribution to education fund Contribution to approved fund Taxable employment income	

Self-Examination Questions

Question 1

Ms Glory was employed for the first time by Fruto International Ltd, a private resident company since 1st January 2018. As a company's Marketing Manager, Ms Glory was given a range of responsibilities.
She has been resident of the United Republic of Tanzania solely in the years 2017 and 2018. Her duties are well balanced by a good package of remuneration which is made up of the following;

(i) Basic salary of Tshs. 800,000 per month and medical service insurance of Tshs. 30,000 per month and medical service insurance of Tshs. 30,000 per month as per the company's policy to its employees.

(ii) Mobility allowances for use when on duty trips within her duty stations of Tshs. 100,000 per month coupled with life insurance of Tshs. 50,000 each month paid directly by the company to the Insurance Company. It is estimated that Ms Glory is spending only 50% of the mobility allowance for the performance of her official duties.

(iii) It is the policy of the company to pay all of its employees lunch allowances of Tshs. 2,000 each per day for 22 days each month.

(iv) Traveling allowances for home-office-home trips of Tshs. 100,000 per month.

(v) The company pays school fees and uniforms for its employees as its contribution as per the National Education Policy. Ms Glory received Tshs. 500,000 which the employer ensured that the sum is spent according to agreed terms.

(vi) A fully furnished residential quarter where the value of furniture itself amount to Tshs. 2,000,000. The company normally recognizes Tshs. 120,000 per month as expense for the provision of the house while the market rent of a house of the same status is Tshs. 150,000 per month. The cost of the house to the company was Tshs. 10 million.

(vii) During 2018, Ms Glory traveled to her home country, Uganda, for an annual leave where she provided consultancy for one month for the following remuneration: Consultancy fees amounting to Tshs. 40,000 per day for 20 days; Upkeep allowance of Tshs. 200,000 for the period of consultancy and free accommodation with market value of Tshs. 150,000.

(viii) During her trip to Uganda, the company paid Tshs. 450,000 for her return air ticket, since the location of the company is Dar es Salaam.

(ix) Ms. Glory acquired a car at a cost of Tshs. 6,000,000 which was fully used in the employment duties.

(x) Ms. Glory also received interest from her Banker on fixed deposit account, Tshs. 200,000.

(xi) Retirement contributions are made to the Social Security Fund where the employer contributes 10% and the employee 10% of the gross monthly salary.

Required:

On the basis of the above information, compute Ms Glory's taxable income for the year of income 2018 (assume today is 31st December 2018).

Question 2

Mr. Hamnazo is a resident employee of Tatua Company Ltd from 1 January 2019. The following information relates to his affairs:

(i) His monthly receipts include basic salary, transport, lunch and medical allowances to the tune of TAS 500,000, TAS 425,000, TAS 175,000 and TAS 50,000 respectively.

(ii) Transport allowance of TAS 425,000 for nine people totaled TAS 3,825,000; and has been given to Mr Hamnazo including each child and his spouse because he lives more than 45 km from the place of employment.

(iii) Self driven car of above 3000 cc was given to him for private use. Expenditure on the car is claimed against taxable income of Tatua Company Ltd.

(iv) Mr. Hamnazo was given an interest free loan of TAS 4,000,000 payable in two calendar years on monthly instalments (assume statutory interest rate of 15% per year).

(v) Other per month benefits enjoyed by Mr. Hamnazo includes electricity and water amounting to TAS 300,000 and TAS 240,000 respectively.

Required:

Establish the monthly taxable income for Mr. Hamnazo for the first month of 2019.

Question 3

Mr. Jaffer had secured a five years employment contract with Kahama Mining Corporation Ltd. His monthly salary was Tshs960,000 per month gross with effect from 1st January, 2016. Mr. Jaffer was also provided with free residential house accommodation by the employer who did not claim ownership allowance. After serving the employer for 2½ years his contract was terminated (by the employer) on 30th June, 2018 because he was suspected of being involved in illegal gold smuggling. He was paid a lump sum compensation of Tshs18,560,000 on termination of his contract of employment. His contract provided for payment of compensation on termination of employment.

Required:

Establish the taxable income of Mr. Jaffer for the year of income 2018.

Question 4

Peter is employed by The Consultancy Ltd as a fashion designer. The following information is available for the tax year 2019.

(1) During the tax year 2019 Peter was paid a gross annual salary of Tshs. 12,000,000 by The Consultancy Ltd.

(2) In addition to his salary, Peter received two bonus payments from The Consultancy Ltd during the tax year 2019. The first bonus of Tshs. 444,300 was paid on 30 April, 2019 and was in respect of the year ended 31 December, 2008. Peter became entitled to this first bonus on 10 April, 2019. The second bonus of Tshs 333,600 was paid on 31 March 2019 and was in respect of the year ended 31 December, 2019. Peter became entitled to this second bonus on 25 March, 2019.

(3) Throughout the tax year 2019 The Consultancy Ltd provided Peter with a diesel powered motor car which has a list price of Tshs 22,500,000/=. The motor car cost The Consultancy Ltd Tshs 21,200,000, and it has 1500cc and was first registered in Tanzania on 2 March, 2017. The Consultancy also provided Peter with fuel for private journeys and does not claim capital allowance for this vehicle.

(4) The Consultancy Ltd has provided Peter with living accommodation since 1 January, 2017. The company had purchased the property in 2016 for Tshs 16,000,000, and it was valued at Tshs 18,000,000 on 1 January, 2018. Improvements costing Tshs 2,013,000 were made to the property during June 2019. The annual value of the rental in that area is Tshs 3,600,000, and the company claim Tshs 1,000,000 as capital and maintenance toward the house.

(5) Throughout the tax year 2019 The Consultancy Ltd provided Peter with two mobile telephones. The telephones had each cost Tshs 250,000 when purchased by the company in January 2019 and 20% of telephone uses were private. It is the company’s policy to provide mobile telephones to all employees.

(6) On 5 January 2019 The Consultancy Ltd paid medical insurance of Tshs 510,000 for the benefit of Peter and all employees of the company were covered by the same programme.
(7) During February 2019 Peter spent five nights overseas on company business. The Consultancy Ltd paid Peter a daily allowance/per diem of Tshs 100,000 to cover the cost of personal expenses such as telephone calls to his family.
(8) The company contributes 15% of basic salary to PPF on behalf of Peter and does not include in taxable employment income.
(9) Peter received a loan of Tshs 1,000,000 during the year 2019 and is payable over three years. The company charges 2% pa on gross loan while the current statutory rate was 17% pa.

Required:
Calculate the Employment income of Peter for the year 2019.

Question 5

Mr. Torres is a Marketing Manager of Food Processors Company Ltd in Tanga Municipal town since July 2019 .

(i) His monthly salary was Tshs.600,000 with effect from 1/7/2019.
(ii) He received a bonus of Tshs.650,000 in September 2019.
(iii) He received Tshs.250,000 entertainment allowance for the year. Of this amount, he spent Tshs.170,000 entertaining potential customers.
(iv) He was provided with fully furnished residential quarters at a nominal rent of Tshs.20,000 per month payable to the employer The cost of furniture to the employer was Tshs.350,000.The market rental value is Tshs 100,000 p.m
(v) He was also provided with subsidized lunches on all working days at leading hotel in the town. He personally paid Tshs.5,000 only for each executive lunch of Tshs.20,000/=. During the year of income 2019, he took a total of 100 of such lunches. This benefit is available to all employees.
(vi) The company provided him with a gardener in order to keep the extensive lawns of his house in a first class condition and a night security guard. They were both paid directly by the company Tshs. 50,000 each per month.
(vii) The company settled Mr. Torres's domestic electricity and water bills of Tshs. 20,000 and Tshs.10, 000 respectively per month directly. The bills were in the name of the company.
(viii) The company issued shares to all interested employees at an issue price of Tshs.600/= per share its market sells at Tshs.750 per share. Mr. Torres purchased 1,000 shares.
(ix) Taking into account the number of official trips made by Mr. Torres, the employer insured his life and paid an annual premium of Tshs.38,000
(x) Mr. Torres purchased a saloon car on 5/10/2019 at Tshs.4,500,000. The employer incurred Tshs. 1,800,000 running expenses. Mr. Torres uses the car to the proportion of two-thirds performance of duties and one-third private.
(xi) Mr. Torres makes retirement contributions to NSSF, 10% of the basic salary by the employer and 10 % his contribution.
(xii) Since he is provided with a residential house by his employer, he offered his own house for rent to NSA Ltd , a company registered in Tanzania, where he receives Tshs. 80,000 a month from July 2019.
(xiii) The employer has employees' non-interest loan scheme. Mr Torres borrowed Tshs. 4 million to finance finishing of his house in August 2019 repayable in twenty monthly installments from 30th September 2019

Required On the basis of the above information, compute Mr. Torres's taxable income assuming he worked for the end of the year of income 2019 and the Bank of Tanzania discount rate at 1st January 2019 was 15 percent.

Question 6

Mrs. Kinabo is a resident employee of NAFAKA Ltd, a resident corporation since 1st January 2012 working at a position of senior accountant. The information relating to her employment remuneration and other benefits during the year of income 2014 is as follows:

(i) Gross annual salary TZS.11,826,617. During the year, she contributed 5 per cent of this salary to an approved pension fund. The employer contributed 15 per cent of the gross salary to the same fund.

(ii) During February, she was provided with a brand new car, whose engine capacity was 3000cc. The car was used for both, private and employment purposes and the private use was estimated at 25 per cent of the total mileage. Annual claimable deduction in relation to maintenance and operation of the car was TZS.5,675,800. The employer claimed this deduction during the year 2014.

(iii) During April, she was provided with fully furnished four rooms house. These rooms were self-contained. One room was solely used as a library established by the employer for the purpose of updating her profession. Another room was used for official purpose while at home. Rent payable for similar house to this in the nearby area is TZS.200,000 per month. She was required to contribute a nominal rent of TZS.20,000 per month to the employer. Claimable annual deduction during the year in relation to the maintenance of this house was TZS.3,600,000. The company's entitlement to this claim for the year 2014 was, however, not allowed by the Commissioner.

(iv) Employees of NAFAKA Ltd are entitled to interest free loans of TZS.15,000,000 since 2012. Mrs. Kinabo secured the loan on 1st January 2014 and agreed to discharge the liability in 60 monthly installments based on average methods with effect from February 2014. By the time this loan was advanced, her basic salary was fixed at TZS.500,000 per month and the annual statutory borrowing/lending rate announced by the Bank of Tanzania was 12 per cent.

(v) The employer paid on her behalf, the remunerations for the warden and security services offered to the house. In aggregate, this amounted to TZS.200,000 per month. Also on 31st December 2014 employer settled the utility bill of TZS.1,600,000 for the house. This was an outstanding bill for the whole year 2014.

(vi) During July 2014, the company also paid TZS.1,000,000 for her scholarship's fees. This was paid to the Open University of Tanganyika where she enrolled for Mastes degree on a part time basis.

(vii) She was receiving monthly alimony allowance from her ex-husband worth TZS.100,000 to support the children. The alimony allowance received by Mrs. Kinabo was not under any judicial order nor written agreement, rather it was an informal agreement between the two ex-spouses.

Required:

Determine the taxable income from employment for Mrs. Kinabo during the year 2014. Show all your workings clearly.

Question 7

Mr. James Musa was appointed Liaison Officer of the University of Dar es Salaam on a salary of TZS.10,800,000 per annum with effect from 1st July, 2016 and posted to Mkwawa University College of Education. He was paid a transfer grant of TZS.1,250,000 on 1st July 2016

His other entitlements included the following:

(i) Responsibility allowance TZS.250,000 per month

(ii) Transport allowance TZS.350,000 per month

(iii) Inconvenience allowance TZS.250,000 per month

He contributed 5% of his salary to an approved Social Security Scheme.

The University of Dar es Salaam provided him with free accommodation, a car and a driver as detailed below:

(i) The university record TZS.200,000 each month as expenses relating to provision of residential house to Mr. Musa while the market rental charge stood at TZS.300,000 per month throughout the year. The University incurred TZS.45,000,000 to construct each on these houses though their current market value is TZS.30,000,000 each.

(ii) In addition to housing benefit, he was also provided with brand new TOYOTA RAV4 worth TZS.50 million. The car had 3000cc and was used for both official and private trips though it was estimated that during the year official trips was three quarters of the whole trips. The University claims for both car maintenance expenditure and Musa's driver salary where during the year it paid TZS.1,080,000 as salary to the Musa's driver.

The University contributed also TZS.2,550,000 per annum towards his children's education at the University of Dar es Salaam Engineering College.

While at University of Dar es Salaam, Mr. Musa took a life assurance policy with the University of Dar es Salaam Insurance (T) Ltd. He paid a monthly premium of TZS.1,000,000 for a capital sum of TZS.6,000,000.

Mr. Musa's aged mother, wife and two children live at his residence at Maswa in Simiyu Region. He is solely responsible for them. The guest house, a two bedroom self contained residential facility at his residence, has been rented to Mr. & Mrs. Bagosha at TZS.250,000 per month for the year of assessment.

Required:

Compute Mr. Musa's chargeable total income, if any, for the year of assessment 2016. State any basic tax principles underlying your computation.

Question 8

(a) Mr. Timoth is on a five years teaching contract at a salary of TZS.554,000 per month with effect from 1st January 2012. After serving for two years his contract was terminated, and a lump sum compensation of TZS.9,930,000 was paid to him.

Required:
Determine the amount of compensation for tax purpose, and state the years in which they are taxable.

(b) Ms YUNIS is employed by International School of Mwanza from 1st August 2008

The following items, conditions and particulars relate to her employment during the year of income 2015:

(i) Her salary per month is TZS.1,300,000
(ii) She is entitled gratuity equivalent to 25% of his basic salary for each successful completed year of service.
(iii) The School provided her with the following benefits:
- Free use of school's motor vehicle, bought six year ago (Toyota Corolla, 1000cc). The Commissioner for Income Tax accepted three quarter of the use as representing free use of the car.
- One night security guard who is on the school's payroll at monthly wage of TZS.250,000.
- Electricity, gas, telephone and water bills amounting to TZS.300,000 per annum. All these benefits were paid directly to the utility companies since they were addressed to the name of employer.
- A residential house for the whole year for which she paid a token rent amounting to TZS.10,000 per month. It is estimated that the market rental value of this house is TZS.160,000 per month.

(iv) Other sums met by the employer during the year included:
- TZS.50,000 per month as entertainment allowance. However, she was not required to account for the amount.
- Monthly duty allowance TZS.120,000.
- She was given TZS.30,000 per month to meet her travelling expenses. She was spending about 25% of such for performing her official duties.
- Free medical services under the arrangement that required the employer to pay medical bills for Ms AKISA, her husband and up to four children. For the year of income 2015, this bill amounted to TZS.300,000.
- TZS.130,000 per month to an insurance company for policy covering her life.

(v) She had two children who are enrolled at the same school. During the year, the school subsidized the school fees and board expenses of the two children amounting to TZS.2,000,000 in total.
(vi) After successful of year 2015, her contract was not renewed due to employer's financial crisis. To this effect, she was paid a lump sum of TZS.2,000,000 as compensation.

Required:

Calculate the total taxable income for Ms. YUNIS for the year of income 2015 and tax liability if her tax bracket is 25%

Question 9

a) Explain the meaning of 'an employment'.
b) Mr. Kizu has just been appointed as a financial consultant of MTANASHATI Ltd for a contract of one year and he will be stationed at MTANASHATI Ltd's premises for the whole period of the contract. His terms of the contract include a weekly remuneration based on hours that Mr. Kizu will be working at MTANASHATI Ltd.

Required

Distinguish between ‘a contract of service’ and ‘a contract for service’ using the information above.

c) Rabia & Assey Ltd employed Ms. Malaika Mukoba as the company human resource officer with effect from 1st September 2010. By the time the company submitted a statement of employment income for year 2010, the following information was revealed to her as her annual emoluments:

i. Basic annual salary TZS.6,000,000
ii. Transport allowance TZS.2,500,000
iii. Lunch allowance TZS.1,500,000
iv. Medical allowance TZS.1,000,000

The employer housed her for free. The annual market rental value of that area was TZS.4,000,000 and the expenditure claimed by the company per annum for that premise was TZS.1,500,000. The contribution made by the employee was TZS.500,000 as rent. Besides the emoluments stated above, the employee had the following benefits:

- A self-driven car for private use, which is 3000 cc, brand new. The company claims expenditure of car maintenance.
- Other benefits included electricity TZS.30,000 and water TZS.25,000 per month in her office.

Though her employment services were terminated on 31st December 2010, the company paid her TZS.30,000,000 as termination benefits (compensation for lost employment). Other income she received in 2010 was TZS.300,000 interest from MBY Bank, TZS.1,500,000 – lease amount from MSK Company for the building she leased to the company since 2009.

Required

Calculate the total income for Ms. Malaika Mukoba for the year of income 2010.

Question 10

Mr. Li Ching Chinese expert was employed by the Nuwe Mining Corporation (NMC) a private resident company on expatriate terms, to construct the Rungwe Coal Mine complex in Mbeya.

He came to the United Republic of Tanzania on 1st February 2013 and started to work with the company on the following day.

(i) He was being paid duty allowance of Tshs Tshs.300,000 per month and a salary of Tshs. 600,000 per month.

(ii) For one month he was in China, he was working with the Government of China which had paid him equivalent to Tshs. 500,000 per month.

(iii) The firm provided him a car (3000cc, of 2011) from the day he arrived in the United Republic. This was wholly used for employment.

(iv) For the first two months of his stay in the United Republic, he was accommodated in a hotel. The firm paid a total of Tshs. 1,500,000 for full board.

After then, he was provided with a fully furnished house. The firm had installed the furniture in the house which belonged to the NPC limited which cost Tshs.6,000,000. NMC was paying a monthly rent of Tshs. 800,000 per month for the house to NPC and was deducting a token rent of only Tshs. 50,000 per month from Mr. Li Ching’s salary. Half of the house was used as an office, and the company was entitled to claim repair and maintenance expenditure.

(v) According to the contract of employment, he had a right of going on leave once annually. However, due to his important role in the project, the firm decided to pay him on 30.5.2013, Tshs. 1,000,000 in consideration of him foregoing his 2013 annual leave.

(vi) On several occasions he had, on behalf of the company, to tender some consultancy services to the State Mining Corporation. As thus the employer company paid him a token sum of Tshs. 500,000 as appreciation for the services as he gave the firm a considerable amount of revenue, in the form of consultancy fees from the State Mining Corporation.

(vii) Water bills for the year totaled Tshs. 80,000 and were fully met by the employer. The bills stood in the name of the employer. Electricity bills (which stood in the name of the employee) totaling Tshs. 50,000 were also met by the company.

(viii) A night watchman earning Tshs. 80,000 was employed by the company for the house. However, he was only responsible for part of the house used for employment purpose. This watchman was also provided with a house by the company.

(ix) When he came to the United Republic, he came with a number of equipment to be used in his work. He had purchased them in China and the company reimbursed him a total of Tshs. 900,000 for such equipment.

(x) The company paid the following annual membership fees for him:

- Tshs. 60,000 as membership fee to the Lion Hotel swimming pool
- Tshs. 100,000 as membership fee to Mining Experts Club
- Tshs. 10,000 to Officers mess
- Tshs. 200,000 to the Safari Club

Though he was working in Mbeya, he used to come to DSM during the week-ends. The firm was also paying for his trip to and from Mbeya in which Tshs. 2,300,000 was used for those trips.

(xi) On the basis of his contract, the company provided him with free lunch which was worth Tshs. 10,000 each and two crates of beer for each month. He had taken only 30 lunches for 2013. A crate of beer was purchased at Tshs. 25,000.

(xii) On one of the trips to DSM he toured Chui Textile Mill, where he was given complimentary of 6 pieces of 'kitenge' dressing materials each worth Tshs. 5,000.

(xiii) At the end of each year he was paid a gratuity of Tshs. 1,500,000.

Required:

From the above information, compute Mr. Li Ching taxable income for 2013 year of income.

Answers to Self-Examination Questions

Answer to SEQ 1

Employment income:

Year of income: 2018

Residence: Resident Individual (for two years)

Basic salary (800,000 x 12)	9,600,000
Medical service insurance	NIL
Mobility allowance (100,000 x 50% x 12)	600,000
Life insurance (50,000 x 12)	600,000
Lunch allowance (2,000 x 22 days x 12)	528,000
Traveling allowance (100,000 x 12)	1,200,000
School fees and uniforms	500,000
Consultancy fee (Uganda) (W3)	13,028,000
Upkeep allowance (Uganda) (W3)	NIL
Free accommodation (Uganda) (W3)	NIL
Trip to Uganda (more than 20 miles)	NIL
Interest from NBC (non-final withholding)	200,000
Retirement contributions (W1) – Add employer's contribution	1,302,800*
Retirement contributions (W1) – Less allowed amount (employer and employee)	**(2,605,600)***
	11,925,200
Housing benefit (W2)	1,800,000
Taxable amount for the year of income 2005	**10,125,200**

Workings:			
1.	**Computation of taxable retirement contributions**		**Shs.**
	Total gross cash remuneration		13,028,000
	Employer's contribution 10%	1,302,800	
	Employee's contribution 10%	1,302,800	
	Total contribution	**2,605,600**	
2.	**Computation of housing benefit**		**Shs.**
	(i) Market rent shs. 150,000 x 12 = Tshs. 1,800,000		
	(ii) 15% x 11,925,200 (total income before housing)		1,788,780
	(iii) Deduction by employer Tshs 120,000x12		1,440,000
	(iv) Compare (ii) and (iii) above, take the greater, i.e.		1,819,620
	(v) Compare (i) and (iv) above, then take the lesser, i.e.		
	Which forms the value of housing benefit.		1,800,000
3.	An individual who has become resident for two years or less for the whole of the life of this individual, her/his taxable income is only that with a source in the United Republic of Tanzania (Section 6 (2).		

Answer to SEQ 2

I	Tshs
Salary	500,000
Transport	425,000
Lunch	175,000
Medical	50,000
Transport for nine	425,000
Car benefit	83,333.3
Loan (PRT) for	50,000.0
Electricity	300,000
Water	240,000
Total monthly income	**2,248,333**

Note:

2.1 The transport allowance of Tshs425,000 amounted to commuting costs which are not wholly and exclusively earned for generating employment income. The law exempt payment providing passage of the individual, spouse of the individual and up to four of their children to or from a place of employment which correspond to the actual travelling cost where the individual is domiciled more than 20 miles from the place of employment and is recruited or engaged for employment solely in the service of the employer at the place of employment.

2.2 The loan benefit has been calculated based on the original value i.e. TSH 4,000,000 because in January no repayment is done until 31 January.

2.3 The self-driven car is assumed to be new.

Answer to SEQ 3

Since the contract term was 5 years and Mr Jaffer was employed for only 2 1/2 , the unexpired contract period was 2 ½ , which equals to 30 months. So Tshs960,000 x30= Tshs28,800,000 could had been earned from the contract if the contract was not terminated.

Since the amount received i.e. Tshs18,560,000 is lesser than that could have been received i.e. Tshs28,800,000; the whole amount received should be apportioned evenly over the unexpired period of 30 months.

Therefore, every month will be allocated Tshs618,667, and Tshs3,712,000 (Tshs618,667 x 6 months) would be taxable for the year ending 31 December 2012,

Hence, the taxable income for the year is Tshs11,520,000 plus Tshs3,712, 000= Tshs15,232,000

Answer to SEQ 4

Computation: Employment Income

Annual Salary	12,000,000
Bonus (444,300 + 333,600)	777,900
Car Benefit (No expenditure claimed)	Nil
Mobile phones (20% x 250,000 x 2)	100,000
Health club membership fee (Non-discriminatory)	Nil
Allowance for personal expenses on business trip	Nil
PPF Contribution (Not included in income)	Nil
Loan Interest Benefit (LIB) – **Note 1**	150,000
Total Income before Housing Benefit	**13,027,900**
Housing Benefit (HB) – **Note 2**	1,954,185
Taxable Employment Income	**14,982,085**

Notes

1. Since the loan given to Peter doesn't satisfy the condition(s), then the LIB thereon is taxable and it is computed as follows. LIB = (17% - 2%) x 1,000,000 = 150,000
2. If an employer provides residential housing to the employee, and the employer claims deduction in relation to capital and maintenance of the house, then the House Benefit is taxable and is calculated as: The lesser of:

(i) Annual market rental value of the house and
(ii) The greater of:
(a) 15% of employee's total income for the year of income excluding House Benefit
(b) Expenditure claimed as deduction by the employer.

Reduced by the employee's rental contribution. So, for the case of Peter Loan Benefit is the lesser of:

(i) 3,600,000; and

(ii) the greater of:

(a) 15% x 13,027,900 = 1,954,185

(b) 1,000,000

Here the greater of 1,954,185 and 1,000,000 is 1,954,185; and the lesser of 3,600,000 and 1,954,185 is 1,954, 185. Hence the Housing Benefit is 1,954,185. Note that, we only consider the chargeable income in computing total income for the purpose of calculating 15% of total income. This is the ruling of section 5(1) which specifies that total income is the sum of chargeable income. In this case if an amount such as the transport allowance to father, mother and 4 children staying more than 20 miles from the employment base is not chargeable income and hence excluded.

Answer to SEQ 5

Computation of Chargeable income of Mr. Torres

Basic salary Tshs 600,000 x 6months		3,600,000
Bonus		650,000
Entertainment allowance (Tshs250,000-TTshs170,000)		80,000
Lunch (Tshs20,000-TTshs5,000) x 100		1,500,000
Gardener and Guard TTshs 50,000 x 2 x 6		600,000
Water & electricity bills (20,000 + 10,000) x 6		180,000
Shares (750-600) x 1000 shares		150,000
Life insurance		38,000
Car expenses (1/3 x 1,800,000)		600,000
NSSF contribution (Employer)s.7(2)(d) 10% x 3,600,000		360,000
Rent (Final withholding s. 86(1)(c)		Nil
Loan benefit (note 3)		250,000
Sub Total		**8,008,000**
NSSF contribution (Employer) 10% x 3,600,000	360,000	
NSSF contribution (Employee) 10% x 3,600,000	360,000	**(720,000)**
Total income before housing benefit		**7,288,000**
Housing benefit (note 2)		**426,600**
TOTAL taxable income		**6,861,400**

Note 1: Computation of housing benefit and its content.

Market value of the part of premises occupied –(100,000 x6) =600,000

15% x Tshs. 7,288,000x 6/12 = TTshs 546,600

Less rent 20,000 x 6 = 120,000

426,600

Expenditure claimed by the employer for the period in respect of the provision of the premises.-not provided.

Therefore the value of premises is Tshs. 426,600

Note 3: Computation of Loan Benefit

Period for the loan = 20 months i.e more than a year

Three-month basic salary TTshs. 600,000 x 3 = TTshs. 1,800,000

Amount of loan Tshs 4,000,000

Since the loan is greater than the three-month basic salary and is repayable in more than a year, the benefit from loan for the year of income 2019 will be:

TTshs. 4,000,000 x 15% x 5/12 (i.e from Aug. to December 2019) = TTshs.250,000

Answer to SEQ 6

Determination of employment income

	TZS
Salary	11,826,617
Employer's contribution to pension fund (15% x 11,826,617	1,773,993
Other benefits	
Car benefit (note 1)	250,000
Loan benefit (note 2)	1,575,000
Warden and security remuneration 200,000 x 9 months x ½ (private portion)	900,000
Utility 1,600,000 x 9/12 x ½ (reduced to period/portion she occupied the house)	600,000
Tuition fee (taxable as it is for part-time studies)	1,000,000
Alimony (taxable if not under judicial order/written agreement (100,000x 12)	1,200,000
	19,125,610
Less: Employee's contribution to pension fund (5% x 11,826,617	(591,331)
Employer's contribution (deductible)	(1,773,993)
Total income from employment income without housing benefit	16,760,286
Add: Housing benefit (note 3)	nil
Taxable income from employment	16,760,286

Notes:

Note 1: Car benefit

Private element qualifies for car benefit provided that employer is entitled to claim maintenance expenditure. It is taxable under the 5th schedule. Brand new car is a car as aged less than 5 years. Taxable benefits is kind for a car of this age and engine capacity 3000cc is 1,000,000.✓

Therefore, car benefit = 1,000,000 x 25 per cent = 250,000

Note 2: Loan benefit

1/1/2014 Loan given	15,000,000
31/12/2014 (15,000,000 – 15,000,000/4)	11,250,000
	26,250,000
Average loan balance 26,250,000/2	13,125,000
Taxable loan benefit year 2014 = 13,125,000 x (12% - 0% x 12/12)	1,575,000

Note 3

Housing benefit is excluded from taxable employment income if employer is not entitled to claim deduction or relief in relation to ownership or maintenance of the house

Answer to SEQ 7

Computation of Mr. Mussa's chargeable Income

TAXPAYER: JAMES MUSSA

SOURCE OF INCOME EMPLOYMENT

YEAR OF INCOME: 2016

PARTICULARS	**AMOUNT (TZS)**
Basic salary (for 6 months)	5,400,000
Transfer grant (relocation allowance)	NIL
Responsibility allowance	NIL
Transport allowance	NIL
Inconvenience allowance	NIL
Housing benefits	NIL
Car benefits	NIL
Salary paid to his driver by the employer	NIL
Contribution toward children's education	NIL
Life insurance contribution	NIL
Employment income before statutory contribution	**5,400,000**

Statutory contribution – employee's contribution	(270,000)
Chargeable employment Income	**5,130,00**
	===========

Answer to SEQ 8

(a) Contract is to specified term and provides for compensation s.7(5) (a)

- Assessable or taxable amount: SHALL NOT EXCEED:
    - Amount to be received in the unexpired period assuming that the contract was not terminated
    - Such amount accrues evenly
    - Taxable in the year (s) immediately following termination
- Compare amount from unexpired period against amount provided for compensation.

Therefore

- Term of contract 5 years (1.1.2012 – 2016)
- Termination (after 2 years) = 31.12.2016
- Unexpired period (from 1.1.2014 – 31.12.2016) = 3 years = 36 months
- Salary from unexpired period:
- Monthly salary 554,000
- 3 years (unexpired) x 540,000 x 36 months = 19,944,000/=

Note: This should be the maximum amount to be taxed in him from compensation.

Amount which would have been received in the unexpired period = 19,944,000

- Compare this figure against amount provided for compensation
  = 19,944,000 Vs 9,930,000

- Take the lesser i.e. 9,930,000 = amount for compensation
- Assessment: Note: is deemed to have accrued evenly in the expired period of the contract i.e. from 2004 – 2006 (using the same annual rate).

Therefore, annual compensation = 9,930,000/3 years = 3,310,000

YOI2013 NIL (year of termination)

YOI2014 3,310,000

YOI2015 3,310,000

YOI2016 3,310,000

(b) Determination of Total taxable income of Ms YUNIS for the year of income 2015

1.	Salary – 12 months	12 x 1,300,000	15,600,000
2.	Gratuity	25% x 1,300,000 x 12	3,900,000

3.	Motor vehicle benefit	125,000 x ¾	93,750
4.	Security Guard	250,000 x 12	3,000,000
5.	Utility bills (electricity, water and gas)		300,000
6.	Entertainment allowance	50,000 x 12	600,000
7.	Duty allowance	120,000 x 12	1,440,000
8.	Travelling expenses	30,000 x 12	360,000
9.	Medical allowances		NIL
10.	Insurance policy-life	130,000 x 12	1,560,000
11.	School fees subsidy		2,000,000
12.	Compensation for termination of contract		2,000,000
13.	Sub-total before – HB		30,853,750
14.	Housing Benefit		1,800,000
15.	Total taxable income		32,653,750
16.	Tax liability 25% there-off		8,163,437.50

NOTE 1: Housing benefit: The lower between

(i) Market rental ……….. 160,000 x 12 = 1,920,000
and

(ii) The greater of
15% x 30,853,750 = 4,628,062.50

And amount claimed = 0

Take the greater i.e. 4,628,062.50

The lesser between 1,920,000 and 4,628,062.50 is = 1,920,000

Reduced by the amount of rent paid by employee = 1,920,000 – 120,000 (10,000 x 12)

Answer to SEQ 9

(a)

- Employment includes in particular:
  - ➢ A position of an individual in the employment of another person;
  - ➢ A position of an individual as manager of an entity other than as partner of a partnership;
  - ➢ A position of an individual entitling the individual to a periodic remuneration in respect of services performed; or
  - ➢ A public office held by an individual, and includes past, present and prospective employment.
  - ➢ Any explanation on contract of service.

(b)

- Employment is determined by the presence of contract of service or employment. The contract of service exists when an employer dictates what

  an employee should do and how, in return for periodic payments.

- The contract of service might exist when:
  - ➢ An employee agrees that, in consideration of a wage or other remuneration, he will provide his own work and skill in the performance of some service for his master.
  - ➢ An employee agrees, expressly or impliedly, that in the performance of that service he will be subject to the other's control in a sufficient degree to make that other master.
  - ➢ The other provisions of the contract are consistent with its being a contract of service
- On the other hand, a contract for service occurs when a contractee hires his own employees, provides and maintains his own tools or equipment; the contractor is paid by reference to the volume of work done; has invested in the enterprise and bear the financial risk; has the opportunities of profit or the risk of loss; and the relationship is not permanent.

- Therefore Mr. Kizu is an employee of MTANASHATI Ltd. i.e. contract of service exist.

Basic salary (6,000,000 x 4/12)		2,000,000
Transport Allowance (2,500,000 x 4/12		833,333.33
Lunch allowance (1,500,000 x 4/12		500,000.00
Medical allowance (1,000,000 x 4/12		333,333.33
Car benefit (1,000,000 x 4/12		333.333.33
Total income before House benefit		4,000,000.00
House benefit:		
A: 4,000,000 x 4/12	1,333,333.33	
B: The greater of the following		

❖ 15% x 4,000,000 = 600,000		
❖ 1,500,000 x 4/12 = 500,000		
The greater is 600,000 compare with 1,333,333.33 take the lesser i.e. 600,000		
600,000 – 500,000		100,000
Total Taxable Income		**4,100,000** **=======**

Answer to SEQ 10

Mr. Li Ching	
Duty allowance (300,000 x 11)	3,300,000
Salary (600,000 x 11)	6,600,000
Salary China (not employed in Tanzania)	NIL
Car benefit (fully for employment	NIL
Hotel expenses	1,500,000
Furniture 6,000,000 x ½ x 9/12	NIL
Leave pay (payment in lieu of leave)	1,000,000
Consultancy fees	500,000
Water bills 80,000 x ½ x 9/12	30,000
Electricity 50,000 x ½ x 9/12	18,750
Watchman salary (employment purpose)	NIL
Equipment (for employment purpose)	NIL
Membership fees - swimming pool) not for - Oysterbay) employment - Safari) purpose	60,000 40,000 200,000

Trips to/from DSM	2,300,000
Lunch 10,000 X 30	300,000
Bear 2 crates = 2 x 25,000 x 11	550,000
Present – Kitenge Chui	NIL
Gratuity	1,500,000
	17,898,750
Add: Housing benefit (Note 1)	3,150,000
Total employment Income	**21,048,750** **========**
NOTE 1:	
A: Market Rent value …. 800,000 x 9 x ½	3,600,000.00
B: (i) 15% of 17,898,750 x ½	1,342,406.25
(ii) Expenditure Claimed by Employer	3,600,000.00
The greater between (i) and (ii)	3,600,000.00
Housing benefit = lesser of A & B	3,600,000.00
Less: Rent paid by Ching (50,000 x 9)	450,000.00
Net Housing benefit	3,150,000.00

SECTION D

COMPUTATION OF TAXABLE INCOME

D2

STUDY GUIDE D2:
COMPUTATION OF INDIVIDUALS BUSINESS INCOME

Get Through Intro

To calculate total income of a person, one needs to calculate the sum of chargeable income from conduct of employment, business and investment. In this Study Guide you are introduced to computation of chargeable income from business of an individual.

Learning Outcomes

a) Explain the meaning of business
b) Identify items of income included in calculating chargeable income from business
c) Identify items of income excluded in calculating chargeable income from business
d) Calculate chargeable income from business
e) Explain presumptive income taxation and its application in Tanzania

Explain the meaning of business and identify items of income included in calculating chargeable income from business.

[Learning Outcome a, and b]

1. Meaning Of Business

Normally, business is demonstrated by presence of contract for service as discussed before. Shortly, that contract for service (sole trading or businesses) occurs when a contractor hires his own employees, provides and maintains his own tools or equipment; the contractor paid by reference to the volume of work done; have invested in the enterprise and bore the financial risk; have the opportunities of profit or the risk of loss; and the relationship is not permanent (Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance [1968] 2 QB 497).

Likewise, in McManus v Griffiths (1997) 70 TC 218 case the judge suggested in deciding whether a person was employed (contract of service or self-employed (contract for service) we should consider the substance of the contractual arrangements rather than their form or the parties' labels (incorporated companies).

Definitions

(i) Business

'Business' includes a **trade**, concern in the nature of trade, **manufacture**, **profession**, **vocation** or isolated arrangement with a business character; and a past, present or prospective business, but excludes employment and any activity that, having regard to its nature and the principal occupation of its owners or underlying owners, is not carried on with a view to **deriving profits**.

(ii) Manufacture

The Act does not define the term manufacturing. Therefore, we can only base on case laws. One of the best case laws which attempted defining this term is the case between Teejan Beverages Ltd vs State Of Kerala and Ors S.R.O. No. 1729 of 1993. Teejan Beverages Ltd vs State Of Kerala and Ors S.R.O. No. 1729 of 1993.

In this case, the appellant was issued with Government letter exempting her from paying sales tax on the ground that she was involved in manufacturing or purification of bottled water because manufacturing of any goods was exempted from the taxes.

However, the letter was later revoked by the government on the basis that purification of water does not satisfy the meaning of manufacturing given in the sale taxes. Hence, the person appealed.

The court definition of manufacturing does not include packing of goods, polishing, and cleaning, grading, drying, blending or mixing different varieties of the same goods by mixing with chemicals or gas, fumigation or any other process applied for preserving the goods in good condition or for easy transportation".

Hence, manufacturing occurs only when raw materials are used (converted) in producing another product which is commercially distinct from the raw materials.

Manufacturing' refers to production of goods commercially different from the raw material used. Teejan Beverages Ltd vs State Of Kerala and Ors S.R.O [1993] TC.1729

(iii) Trade

Similarly, no definition of trade is given in the Act. However, cases laws have provided indicators " badges of trade" which can be used to tell whether a trade is being contacted.

These indicators include:

a) Methods of acquisition; assets acquired through inheritance or gifts might indicate no trade motive than those acquired through purchases (Taylor v Good [1974] 49TC277).

b) Second, length of the period of ownership; purchasing and selling an asset in hast might indicate trading while holding the assets for long period may indicate investment (Marson v Morton and Others [1986] 59TC381).
c) Third, frequency or number of similar transactions by the same person; too many similar transactions might imply trade (CIR v Livingston and Others [1926] 11TC538).
d) Fourth, doing supplementary work on or in connection with the asset realised to increase saleable condition might indicate trading (CIR v Livingston and Others [1926] 11TC538.
e) Fifth, circumstances that were responsible for the realisation; forced realisation for example in emergency might indicate absence of trade (CIR v Livingston and Others 11TC538).
f) Sixth profit motive; reason for transaction involved being gain profit from it rather than holding it as an investment (Salt v Chamberlain [1979] 53TC143).
g) Also nature of assets involved; if the nature of the assets involved is not always involved in trade, it might not indicate trade. This assets include purchase of shares might highly indicate investment than trading and purchasing of classic cars may be for person consumption than trading while purchase of chemical for example might definitely indicate trade (CIR v Fraser [1942] 24TC498).
h) Finally, existence of similar trade transaction, the close the proximity of the transaction undertaken to the existence trade transactions the more it can be taken to be a trade transaction (Harvey v Caulcott [1952] 33TC159).

Definition

'Trade' is an act of providing goods or services to others in exchange for a reward.

Cambridge dictionary

However, in many cases presences of these badges of trade do not indicate presence or absence of trade.

Therefore, all facts surrounding the transaction should be considered. For instance, the definition of business above includes even "isolated arrangement with a business character" which might means trading.

For instance, in a case of CIR v Fraser [1942] 24TC498; Fraser bought a large consignment of whisky and sold it at profit, using the above indicators the transaction could be none trade transaction. However, the court decided that "The purchaser of a large quantity of a commodity like whisky, greatly in excess of what could be used by himself, his family and friends, a commodity which yields no pride of possession, which cannot be turned to account except by a process of realisation, I can scarcely consider to be other than an adventurer in a transaction in the nature of a trade. Most important of all, the actual dealings of the respondent with the whisky were exactly of the kind that take place in ordinary trade."

(iv) Profession

'Profession' any type of work that needs special training or a particular skill, often one that is respected because it involves a high level of education. Cambridge dictionary

(v) Vocation

'Vocation' is a type of work that you feel you are suited to doing and to which you should give all your time and energy, or the feeling that a type of work suits you in this way and indicates a calling.

Vocations include religion or high-minded service to others, a bookmaker and a jockey, authors, dramatists and professional singers. Graham v Green [1925] 9TC309

2. Items Of Income Included In Calculating Chargeable Income From Business

Business income items which are chargeable

Income in connection with businesses income (contract for service) means:

a) service fees;
b) incomings for trading stock;
c) gains from the realisation of business assets or liabilities of the business
d) Gains from realisation of the person's depreciable assets of the business;
e) amounts derived as consideration for accepting a restriction on the capacity to conduct the business;
f) gifts and other ex gratia payments received by the person in respect of the business;
g) amounts derived that are effectively connected with the business and that would otherwise be included in calculating the person's income from an investment; and
h) Other amounts including reverse of amounts as bad debts, bad debts writing off, discount allowed, fluctuations in foreign exchanges and seizures of untaken deposits and advances (Section 8(2)).

Identify items of income excluded in calculating chargeable income from business; calculate chargeable income from business; explain presumptive income taxation and its application in Tanzania [Learning outcome c, d and e]

3. Items Of Income Excluded In Calculating Chargeable Income From Business

Excluded business income

According to Section 8(3) of the Income Tax Act 2004, exempt business income, final withholding payments and non-business income should be excluded in computing business income. Both exempt income and final withholding income items were covered in the employment income Section. So in this Section they are not discussed. Please take time to peruse them. In addition receipt from realisation of capital assets should be excluded as well because they are used in computing gain from realisation of assets.

4. Calculation Of Chargeable Income From Business

By now we have learnt that not all income from business are taxable, some are final withholding payments, some are exempt income and some simply not related to business. Also we saw how to identify allowable deductions and non-deductible expenses when computing business income. This Section deals with how to establish chargeable income from business. The business income of sole trade is can be computed on cash or accrual basis unless specifically required by tax laws, while corporations compute their business income on accrual basis.

Definition

'Chargeable business income' of resident person, includes all his or her income for the year of income irrespective of the source of the income, while chargeable income of non-resident persons income only to the extent that the income has a source in the United Republic. Finally, chargeable income of a resident corporation which has perpetual unrelieved loses for the last consecutive two years is the turnover of such corporation for a year of income, expect those in agriculture, health or education businesses.

However, all business persons prepare their accounting records using General Accepted Accounting Practices (GAAPs). So for tax purposes, we do not establish new financial statements. But we adjust profit or losses shown by the accounting statements by adding items which are not taken into accounting by GAAPs and deducting items which are not allowed by tax laws but included by the GAAPs. The statement below can help us when computing taxable employment income.

Computation of Chargeable Business Income

Items		TZS
Profit or loss as per account		XX
Add: None allowable expenses		
• Consumption expenditure	xx	
• Excluded expenditure	xx	
• Capital expenditure	xx	xx
Add: Business income not included		
• Compensation	xx	
• Loss on realization of business assets/liabilities	xx	xx
Less: Non-taxable business income		
• Final withholding payments	xx	
• Gain on disposal of fixed assets	xx	(XX)
Less: Business expenses not deducted		
• Capital allowances	xx	(XX)
Taxable business income		XX

5. Presumptive Income Taxation And Its Application In Tanzania

Small traders, who operate mostly without keeping proper business records, are charged income tax by **presumptive tax system** based on the annual turnover of their business. **Presumptive tax system** involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts.

In Tanzania individuals are taxed based on their annual turnover. The taxpayers under this system are not obligated to prepare and submit audited accounts to the TRA. However, they may opt not to adopt the system and prepare audited accounts and pay tax based on profits.

Presumptive methods of taxation are thought to be effective in reducing tax avoidance as well as equalizing the distribution of the tax burden.

The term "**presumptive**" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method. As discussed below, this presumption may or may not be rebuttable.

The concept covers a wide variety of alternative means of determining the tax base, ranging from methods of reconstructing income based on administrative practice, which can be rebutted by the taxpayer, to true minimum taxes with tax bases specified in legislation. **Taube and Tadesse (1996).**

Conditions which qualify for presumptive tax system

1. The taxpayer must be a resident individual
2. The annual turnover of the business does not exceed the threshold **of Tshs20 million.**
3. The individual's income for a year of income consists exclusively of income from a business having a source in the United Republic. If income is derived from other sources such as employment and/or investment the presumptive scheme cannot be used.
4. The individual does not elect to disapply this provision for the year of income.

2.3 Rates of tax under presumptive taxation

Under this system, tax payable is established depending on the level of record keeping of the taxpayer. Failure to keep complete records necessitates establishment of tax payable by estimation settled between the TRA officers and taxpayers. The turnover bands and their tax rates are as stipulated below:

Annual turnover	Tax payable when records are incomplete	Tax payable when records are complete
Where turnovers does not exceed Tshs. 4,000,000	NIL	NIL
Where turnover exceeds Tshs.4,000,000 but does not exceed Tshs.7,500,000	Tshs. 150,000	3% of the turnover in excess of Tshs. 4,000,000
Where turnover exceeds TSHS. 7,500,000 but does not exceeds Tshs. 11,500,000	Tshs. 318,000	Tshs. 135,000+3.8% of the turnover in excess of Tshs. 7,500,000
Where turnovers exceeds Tshs. 11,500,000 but does not exceed Tshs. 16,000,000	Tshs. 546,000	Tshs. 285,000+4.5% of the turnover in excess of Tshs.11,500,000
Where turnover exceeds Tshs. 16,000,000 but does not exceed Tshs. 20,000,000	Tshs. 862,500	Tshs. 487,000+5.3% of the turnover in excess of Tshs. 16,000,000

Self-Examination Questions

Question 1

Mr. Mwamba Kimweri is a Tanzanian self-employed, managing a health shop. His profit or loss account for the year ended 31st March 2019 is as follows:

	TZS '000'	TZS '000'
Sales (note 2)		338,050
Opening stocks	20,000	
Purchases	110,500	
	130,500	
Closing stock (note 3)	(27,500)	(103,000)
Gross profit		**235,050**
Loss on sale of fixed assets	5,000	
Loss on sales of land	10,000	
Depreciation of equipment	8,900	
Wages and salaries (note 4)	61,575	
Light and heat (note 1)	3,650	
Telephone (note 5)	5,700	
Repairs and renewals (note 6)	20,360	
Bad debts expenses (note 7)	4,780	
Professional fees (note 8)	11,400	
Relocation expenses (note 9)	3,250	
Other expenses (note 11)	4,400	
Motor vehicle expenses (note 10)	1,690	
		(140,705)
Net Profit		**94,345** =======

Notes to accounts

Note 1 – Private Accommodation

Mr. Kimweri and his family live in an apartment situated above the business premises. It is his policy to treat two-fifth (2/5) of the expenditure on the premises occupied as private expenditure unless it can be specifically allocated.

Note 2

Mr. Kimweri took product from the store at a sale price of TZS.1,000,000. This drawing was recorded in sales figure at the cost price of TZS.700,000.

Note 3

Closing stock included a contingency reserve of TZS.9,000,000 for loss of stock by fire.

Note 4 – Wages and Salaries

Self – Drawings	18,000,000
Mrs. Kimweri – Secretarial services	7,500,000
Other staff	28,000,000
Mr. Kimweri's daughter – casual work	8,075,000
	61,575,000 ========
Note 5 - Telephone	
One-third (1/3) of the amount charged as telephone cost was for private use	
Note 6 – Repairs and Renewals	
Decorating the apartment	950,000
Purchased a price of small equipment to be used in a shop	3,350,000
Major restoration of the building	15,000,000
General maintenance	1,060,000
	20,360,000 ========
Note 7 – Bad debts	
Trade debts written off	1,000,000
Increase in general provision	3,780,000
	4,780,000 ========
Note 8 – Professional fees	
Accountancy	1,500,000
Legal fee in connection with purchase of a used fixed assets	3,800,000
Computer services	2,500,000
Legal fee incurred in defending Mr. Kimweri from speeding offence	1,700,000
Trade subscriptions	800,000
Subscription to sundry Lane Golf Club	1,100,000
	11,400,000 ========

Note 9 – Relocation expenses

This expenditure was incurred in transferring the business to new larger premises.

Note 10 – Motor vehicle Expenses

One forth (1/4) of motor car running expenses was for Mr. Kimweri private mileage. Included in charge is TZS.150,000 for speeding fine incurred by Mr. Kimweri whilst delivering goods to a customer.

Note 11 – Other expenses

Training course for Mr. Kimweri to enhance managerial skills	1,900,000
Fine for a traffic offence	450,000
Misappropriation of company funds by an employee	550,000
Donation to a political party	1,500,000
	4,400,000 =======

Note 12

Depreciation allowance for depreciable assets as estimated by Mr. Kimweri's tax consultant amounted to TZS.33,250,000.

Note 13 – Other information

Mr. Kimweri had a tax loss brought forward of TZS.4,000,000 as at the previous financial year. He has 4 children under the age of 15 and savings account balance of TZS.7,800,000.

Required:

Calculate Mr. Kimweri's adjusted profit, after capital allowances, for the year ended 31st March 2019.

Question 2

Uwimana is a business lady in Dar es Salaam city. During the year ended 31/12/2017, her accountant submitted the following information for income tax purpose:

	TZS."000"	TZS."000"
Revenues		250,000
Cost of sales		(120,000)
Gross profit		130,000
Less: expenses		
Salaries	35,000	
Rent	10,000	
Bad debt	2,000	
Electricity	18,000	
Advertising	6,000	
Insurance	5,000	
VAT	20,000	
Telephone	6,000	(102,000)
Profit before Tax		28,000
		=======

Additional information:

(i) Rent was paid on 1/1/2017

(ii) Of the bad debt expense, TZS.1,000,000 relates to a debtor who was declared bankrupt

(iii) Salaries of TZS.5,000,000 remained outstanding

(iv) A quarter of the insurance expenses has expired

(v) Telephone expenses relate to the airtime loaded on Uwimana's mobile which she uses for both private and business purposes.

Required:

Compute the taxable income and the tax liability of Uwimana.

Answers to Self-Examination Questions

Answer to SEQ 1

TAXPAYER: MR. KIMWERI		
YEAR OF INCOME: 2019		
STATEMENT OF CALCULATING TAXABLE INCOME		
DETAILS	**TZS'000'**	**TZS'000'**
Net profit as per accountants		94,435
Add: Items debited in P & L account not allowed		
Loss from sale of land	5,000	
Loss from sale of land	10,000	
Depreciation of Equipment	8,900	
Light and Heat (two fifth) $^2/_5$ x 3,650)	1,460	
Self drawing	18,000	
Telephone (one-third for private for Private use) ($^1/_3$ x 5,700)	1,900	
Purchased a piece of small equipment to be used in a shop	3,350	
Major restoration of the building	15,000	
Increase in general provision	3,780	
Legal fee in connection with purchase of a used fixed assets	3,800	
Legal fee incurred in defending Mr. Kimweri from speeding offence	1,700	
Subscription to Sundry Lane Golf Club	1,100	
Speeding fine	150	
Motor vehicle running expense (1,690 – 150) x ¼ (one forth for Private)	385	
Fine for a traffic offence	450	
Donations to the Democratic Labour Party	1,500	76,475
		170,820
Add: Goods taken for Private use (1,000 – 700)		300
Deduct:		171,120
Contingent Reserve	9,000	
Tax losses brought forward	4,000	(46,250)
Depreciation allowance	33,250	
Adjusted business income		124,870

Answer to SEQ 2

STATEMENT OF COMPUTING TAXABLE INCOME AND TAX LIABILITY
TAX PAYER: UWIMAMA
SOURCE OF INCOME: BUSINESS
YEAR OF INCOME: 2017

DETAILS	AMOUNT (TZS'000')	AMOUNT (TZS'000')
Profit before tax		28,000
Add back: Disallowed expenses		
VAT	20,000	
Telephone	6,000	
Bad debts (Not proven to be bad)	1,000	
Insurance (Unexpired)	3,750	30,750
Taxable business income		58,750

Tax Liability = A + Tax rate* [B-C]
= 1,177,200 +30% [58,750,000- 8,640,000]
= TZS 16,210,200√

SECTION D

COMPUTATION OF TAXABLE INCOME

D3

STUDY GUIDE D3: INDIVIDUAL INVESTMENT INCOME

Get Through Intro

Investment income comes from holding an asset for a certain period in anticipation of getting periodic income /and or getting capital gain from its realisations. It is very closely related to business activities, but it differs in two aspects: it is just a minor undertaking of a person and there is no close link to business activities. This Study Guide is specifically aimed at elucidating items which are included in computation of investment income and those items which are excluded when computing investment income. In doing so, it covers sections in the Income Tax Act to enable you to establish correct taxable investment income. Sections from Income Tax Act Cap 332 are being referred to throughout this Study Guide. Knowledge of determining investment income is essential in understanding how investors are taxed.

Learning Outcomes

a) Explain the meaning of Investment
b) Differentiate between Investment income and Business Income
c) Describe inclusions /component of investment income
d) Describe exclusions /income not Included in Investment income
e) Explain allowable and non-allowable deductions of investment income
f) Establish chargeable Investment Income

Explain the meaning of Investment; differentiate between Investment income and Business Income and describe inclusions /component of investment income

[Learning outcome a, b, and c]

1. Meaning Of Investment And Its Differences From Business

1.1 Investment

Section 3 of the Act provides definitions of the term **investment** as the owning of one or more assets of a similar nature or that are used in an integrated fashion, on similar terms and subject to similar conditions, including as to location

Investment can be

(i) past,
(ii) present and
(iii) prospective investment,

But investment does not include

(i) Business,
(ii) Employment and
(iii) The owning of assets, other than investment assets, for personal use by the owner

This definition covers any assets unless they are held primarily for personal use by the person who owns them and are not used in the production of profits. The definition of investment excludes employment or business. If the issue arises as to whether certain activities of a person constitute one or more investments, there are two tests to check it. The first is whether the assets held are of a similar nature. *For example: A block of shares may constitute a single investment.*

The second test is whether the assets are used in an integrated fashion, on similar terms, and subject to similar conditions, including as to location. *For example: A house that is held passively and rented out with associated furniture will constitute a single investment*

Any liabilities incurred with respect to the asset or assets held are also part of the investment.

1.2 Investment vs business

It is important to differentiate when someone is doing business or investment because of difference in tax rates. Unlike a business person who expects benefiting from regular or many frequent transactions, someone making an investment normally takes a long term view of his/her activities. For example, shareholders of a corporate might hold shares for expectation of getting periodic dividends and long term capital gains after disposing of the shares. However, share brokers in most cases buy shares in order to profit from short term rises or falls in share prices. So if the share brokers get dividends or capital gain from realisation of shares, these incomes are more likely to be business incomes than investment income.

Furthermore, another important distinction between business and investment activities is that business activities are normally the major occupations of a person while investment activities are subsidiary ones. Take an example of interest income; the interest income received by an individual from a saving or fixed deposit account might be investment income, while, the interest income received by financial institutions or money lenders is definitely business income. Likewise, rent income received by property management company is business income, the same income received by a trading company owning a few properties may be investment income.

Finally, it is important to look at the substance of the income, not the form of it. For instance, interest received from the business accounts is business income not investment income. Also income from short term investments using business funds are business income not investment income as income from letting extra business space.

2. Component of Investment Income

According to section 9 (1) of the Income Tax Act Cap 332, the following items are investment income.

(a) Dividend,
(b) Distribution of a trust,
(c) Gains of an insured from life insurance,
(d) Gains from an interest in an unapproved retirement fund,
(e) Interest,
(f) Natural resource payment,
(g) Rent
(h) Royalty;
(i) Net gains from the realisation of investment assets of the investment
(j) Amounts derived as consideration for accepting a restriction on the capacity to conduct the investment.

Definitions

'Royalty' means any payment made by the lessee under a lease of an intangible asset and includes payments for:

(a) the use of, or the right to use, a copyright, patent, design, model, plan, secret formula or process or trademark;
(b) the supply of know-how including information concerning industrial, commercial or scientific equipment or
experience;
(c) the use of, or right to use, a cinematography film, videotape, sound recording or any other like medium;
(d) the use of, or **right** to use, industrial, commercial or scientific equipment;
(e) the supply of assistance ancillary to a matter referred to in paragraphs (a) to (d); or
(f) a total or partial forbearance with respect to a matter referred to in paragraphs (a) to (e), but excludes a natural resource payment. **Section 3**

'**Natural resource'** means minerals, petroleum, water or any other non-living or living resource that may be taken from land or the sea. **Section 3**

'Natural resource payment' means any payment, including a premium or like amount, for the right to take natural resources from land or the sea or calculated in whole or part by reference to the quantity or value of natural resources taken from land or the sea. **Section 3**

'Interest' means a payment for the use of money and includes a payment made or accrued under a debt obligation that is not a repayment of capital, any gain realised by way of a discount, premium, swap payment or similar payment.

'Gains of an insured from life insurance . Section 60(3) provides the meaning of the term "gains of an insured from life insurance" as the extent to which proceeds from life insurance paid by an insurer exceed premiums paid to the insurers with respect to the insurance

'Gains from an interest in an unapproved retirement fund'

Gains from an in interest in an unapproved retirement fund" is defined in section 63 to mean the extent to which retirement payments made by an unapproved retirement fund in respect of an interest in the fund exceed retirement contributions made to the fund in respect of the interest.

Net gain from realisation of investment assets

The net gain from realisation of investment assets is calculated as follows:

(a) Total of all gains from the realisation of investment assets during the year
(b) Less
    (i) Total of all losses from the realisation of investment assets of the investment during the year;

(ii) Any unrelieved net loss of any other investment of the person for the year.

(iii) Any unrelieved net loss of an investment for a previous year of income (Section 36(3)).

Definitions

'Investment asset' means shares and securities in a corporation, a beneficial interest in a non-resident trust and an interest in land and buildings but does not include:

(a) business assets, depreciable assets and trading stock;

(b) a private residence of an individual that has been owned continuously for three years or more and lived in by the individual continuously or intermittently for a total of three years or more, other than a private residence that is realised for a gain in excess of 15,000,000 shillings;

(c) an interest in land held by an individual that has a market value of less than 10,000,000 shillings at the time it is realised and that has been used for agricultural purposes for at least two of the three years prior to realisation; and

(d) shares or securities listed on the Dar es Salaam Stock Exchange that are owned by a resident person or a non-resident person who either alone or with other associate controls less than 25% of the controlling shares of the issuer company.

'**Unrelieved net loss**' of an investment for a year of income is the excess of losses over gains from the realisation of investment assets of the investment during the year of income.

3. Income Not Included In Investment Income

Section 9(3) provides that the following amounts are to be excluded in calculating gains or profits from conducting an investment:-

(i) Exempt amounts
(ii) Final withholding payments; and
(iii) Amount that are in calculating the person's income from any employment or business.

Describe exclusions /income not Included in Investment income; explain allowable and non-allowable deductions of investment income, and establish chargeable Investment Income. [Learning outcome d, e, and f]

4. Allowable And Non Allowable Deductions Of Investment Income

4.1 Allowable deductions

As it was for business income, taxable investment income is established after deducting allowable deductions. Almost all the criteria for allowing or not allowing expenses we saw in business income apply here as well. In short, only expenses incurred 'wholly and exclusively' in the production of business income are allowable expenses (Section 11(3)). Therefore, only expenditure incurred for sole purposes of producing investment income are allowable expenses and expenditure incurred not wholly and exclusively for business purposes is not allowable.

4.2 Non-allowable deductions

Likewise, deduction of capital, consumption and excluded expenditures are not allowed (Section 11). Also, unlike business persons who are allowed to deduct depreciation annual allowance under the third schedule of Income Tax Act Cap 332, investors cannot claim depreciation charges on their investment assets. Therefore, depreciation charges of investment assets calculated under taxpayers' accounting policies are not allowed too.

5. Chargeable Investment Income

By now we have learnt that not all income from investment are taxable, some are final withholding payments, some are exempt income and some are simply not related to investment. Also we saw how to identify allowable deductions and non-deductible expenses when computing investment income.

This section deals with how to establish chargeable income from investment activities. The investment income of a sole trader can be computed on cash or accrual basis unless specifically required by tax laws, while corporations compute their investment income on accrual basis.

‘**Chargeable investment income’** of resident person, includes all his or her income for the year of income irrespective of the source of the income, while **chargeable income** of non-resident persons income only to the extent that the income has a source in the United Republic.

Self-Examination Questions

Question 1

Mr. Mkongo is a resident individual with the following sources of income during the year of ncome ended December 31, 2017:

1. Sold shares of Atmos Supplies Ltd, a resident company listed in the Dar es Stock Exchange, whereby he owns 17% of controlling shares. These shares were bought at TZS.5,200,000 and sold for TZS.10,400,000.
2. Received TZS.28,000,000 from Mashaka Assurance Ltd a resident company, as proceeds from his life insurance that has matured in 2017 after 10 years of contributions. Mkongo has been contributing of TZS.100,000 monthly.
3. Received bank interest of TZS.5,000,000 in relation to a fixed deposit with Mwananchi Bank Ltd.
4. Mkongo is a member of ZSSF, a Zambian retirement fund, where he has been making monthly retirement contributions of equivalent to TZS.120,000 for 5 years until last year when he retired. This year he received a lumpsum retirement payment of equivalent to TZS.30,000,000.
5. Received TZS.200,000,000 for sale of a land situated at Kariakoo, Dar es Salaam. This land was acquired in 1986 for TZS.8,000,000. Legal fees for the sale amounted to TZS.12,000,000.
6. Received dividend of TZS.400,000 from Musiba Ltd. This was a resident corporation where he own 29% of the shares.
7. He was paid TZS.280,000 by Fjardings Trust, a Swedish registered trust as a compensation for cancellation of his membership due to old age. Mkongo has made cumulative contributions of TZS.200,000,000 for the whole period of membership.
8. Sold a residential house of which he had been occupying occasionally for more than three years for TZS.700,000,000. The house was bought for TZS.400,000,000.
9. Dividends amounting to TZS.12,400,000 were received from Gatan Ltd, a non-resident corporation, which is listed in DSE. 24% of Gatan Ltd shares are owned by Kamaka Ltd, a resident company.

Required:

Determine investment chargeable income of Mr. Mkongo for the year of income 2017 use all 1 to 9 notes mentioned above; (where the amount is not taxable write nil).

SECTION D

COMPUTATION OF TAXABLE INCOME

D4

STUDY GUIDE D4: PROCEDURES FOR PAYMENT OF TAX

Get Through Intro

While complying with the Income Tax Act, Cap 332 following the due dates is very important as any delay in filing returns and paying tax can lead to heavy penalties. This Study Guide discusses in detail the methods of tax payments, contents and due dates for submission of provision and final returns, types of assessments as well as documents required to be maintained by the taxpayers consequences of not complying with the Income Tax Act, Cap 332.

As a tax consultant, you will need this information to advise clients on how to minimize penalties. A thorough understanding of this topic is important for your examination, as well as in your professional life.

Learning Outcomes

a) Describe tax payment procedures by withholding system.
b) Describe tax payment procedures by installment.
c) Describe tax payment procedures by return.
d) Explain concept tax assessments and notice of assessment
e) Identify documents required to be maintained by Taxpayers.
f) Describe the “EFD” system, its benefits and the possible revenue risks involved

Describe tax payment procedures by withholding system; describe tax payment procedures by installment and describe tax payment procedures by return.

[Learning outcome a, b, and c]

1. Tax Payment Procedures By Withholding System

In order to ease tax collection and hence reduce both tax administration cost as well as compliance costs of tax payers, many tax systems including Tanzania have adopted a system of tax deduction at source. This system is known as withholding tax system. In this system the amount of tax is retained/ withheld by one person when making payments to another person in respect of goods supplied or services rendered by the payee. For instance, instead of collecting taxes from hundreds of employees, the tax authority demands payment of tax from a single employer who is withholding PAYE before paying employees' salaries.

1.1 Payments that are subject to withholding taxes

The following payments are subject to withholding taxes:

- Payment that is to be included in calculating the chargeable income of an employee from the employment of a resident employer
- Payment of investment return including dividend, interest, natural resource payment, rent or royalty.
- However the withholding tax does not apply when payments are made by individuals unless made for conducting a business
- Payment in respect to service fee and contract payments
- Payment for technical or management services made by resident person to another resident person in mining business and payment made by resident person for a service fee or an insurance premium with a source in United Republic to a non-resident person. However, individuals who are not in business cannot withhold taxes, and exempt amount is not subject to withholding payment.
- Payment made by government and its institutions in respect to supply of goods and services
- Payment in respect of money transfer commission paid or payable to money transfer agents

Classification of withholding payments

There two types of withholding payments

(i) Final Withholding payments
(ii) Non-final withholding payments.

Non final withholding tax is taxed at the source and in the hands of the tax payer. It does not relieve a person from further tax. Therefore, the income is also included in the computation of taxable income and tax liability but the tax paid is deducted in the computation of tax payable.

Final withholding payments are those which are taxed only at the source and their tax liability under income tax is satisfied. This kind of withholding tax is treated as discharging the recipient's tax liability, and no tax return or additional tax is required on taxed income. The classification of final or non-final withholding payments depend on whether the parties involved are resident or non-resident, persons or natural person i.e. individual doing business or investment, foreign or domestic.

The following are final withholding payments:

(a) Dividends paid by:

(i) a resident corporation;
(ii) non-resident corporation to a resident individual, other than a dividend received by an individual in conducting a business;

(b) Interest paid by financial institution to a resident individual where the interest is paid with respect to a deposit held with the institution, other than interest received by the individual in conducting a business; or foreign source interest paid to a resident individual;

(c) Rent paid to a resident individual under a lease of land or a building and associated fittings and fixtures, other than rent received by an individual in conducting a business; or foreign source rent paid to a non- resident individual;

(d) Interest paid to a unit trust.

(e) Management or technical service fees paid by a resident person to another resident or service fee or an insurance premium with a source in Tanzania paid by resident person to a non-resident person rather than through domestic permanent establishment in conducting mining business.

(f) Interest paid to a unit trust.

(g) Capital gains from realisation of interest in land or building (or both) when received:

- **By resident individuals** whose income consists exclusively of either or both of income from any employment or capital gains from realisation interest in land and building in Tanzania and
- **By non-resident persons** without domestic permanent establishments whose their income consists exclusively of either or both of income from capital gains from realisation interest in land and building in Tanzania are not required to file tax returns, consequently the gains are final withholding payments

1.2 Filing requirements by withholding agents

Withholding agents are required to pay income taxes withheld to TRA within 7 days after the end of each calendar month. In addition, the withholding agents are required to file (to the Commissioner) statements accounting for the amount withheld within 30 days after the end of each 6 month calendar period (Section

84(1)). The statements should show: payments made by the agent during the period that are subject to withholding, the name and address of the withholdee, income tax withheld from each payment; and any other information that the Commissioner may prescribe (Section 84(2)).

Furthermore, a withholding agent is required to prepare and serve separately for each period a withholding certificate to the withholdee. The certificate shall cover a calendar month and is served within 30 days after the end of the month. The statement should include, the name and address of the withholdee; income tax withheld from each payment; and any other information that the Commissioner may prescribe.

In the case of employment income, a withholding certificate covers the part of the calendar year during which the employee is employed; and served by 30th January after the end of the year (assuming calendar year) or, where the employee has ceased employment with the withholding agent during the year, no more than 30 days from the date on which the employment ceased.

Example

Robots and Assembler Design Makers Ltd withheld taxes on employees' salaries, amounting to Tshs10,000,000 on 3 January 2018, and on dividends amounting to Tshs8,000,000 which were paid to shareholders on 28 February 2018.

Required:

State the due dates of filing the withholding tax statements if the company uses calendar year as its accounting year.

Answer

All withholding agents are required to file statements accounting for the amount withheld within 30 days after the end of each 6 month calendar period. So, the person should file the statement on or before 30th July 2018 for these payments, and should again file it on or before 30 January 2019.

Withholding Tax Base

Tax shall be computed on the gross amount paid without deduction of expenses or allowances. The withholding tax base amount shall be exclusive of any value added tax or any other indirect tax included in the payment amount.

Withholding Tax rates

The tax to be withheld is based on a certain percentage of the gross income depending on the nature of the income. The taxes to be withheld for the various payments are as shown below:

WITHHOLDING/INVESTMENT TAX RATES		
Tax source	**Resident**	**Non-Resident**
Dividends to companies controlling 25% of shares or more	0%	10%
Dividends from DSE listed company	5%	5%
Dividends from other companies	10%	10%
Other withholding payments	15%	15%
Interest	10%	10%
Royalties	15%	15%
Technical services (Mining)	5%	15%
Transport non-resident operator/charterer without permanent		5%
Rental income	10%	15%
Insurance premium	0%	5%
Natural resource payment	15%	15%
Service fees		15%
Capital gain for disposal of entity's asset	10%	20%

Advantages of withholding taxes

The system minimises the possibility of evasion or underreporting of income because the agent will file the correct tax and details for fear of penalties

A steady flow of government revenue is guaranteed

- The method is convenient to the taxpayers as they are spared of huge tax bills at the end of the year and hence are freed from the need to file returns and other administrative costs.
- It is economical for the Revenue Authority as it does not incur any costs in the collection of the taxes

Problems of withholding tax administration

(i) Non-deduction
Some organization pays their suppliers without deduction of withholding taxes, the reasons may be
- Out of ignorance
- To help them

(ii) Non- remittance
Some tax agents (payer) deduct and fail to remit but rather prefer to make use of the money in their operations

(iii) Use of wrong rate
Wrong rates are often applied either ignorantly or to help the taxpayer

2. Tax Payment Procedures By Installment

Normally, business and investor taxpayers are required to pay their taxes in installments; and employees who are employed by non-resident employers are also required to pay their taxes in installments because the employers are not required to withhold the taxes (Section 88(1)); unless permitted by the Commissioner of Domestic Revenue to not pay taxes by installments (Section 89(7)).

The calculation of amount of the installments starts with estimation of tax payable of a person at the start of the year.

The computation of tax payable requires that the taxpayer estimate his or her future gross income, deductible expenditures etc. and properly uses tax rates to determine it. Then, the taxpayer uses the formula given in the Income Tax Act, Cap 332 to compute how much of the estimated tax payable should be paid in each installment.

Generally, taxpayers might pay their tax liabilities in 4 installments i.e. on or before the last day of the 3rd, 6th, 9th and 12th months of the year of income (Section 88(2)). However, when a taxpayer does not have an accounting period of 12 months, the installments should be made every 3 months and the last one at the last day of the year (Section 88(2)).

Specifically, the amount of each installment of income tax payable by an installment payer for a year of income is calculated according to the following formula:

$$\frac{A - C}{B}$$

Where:

A is the estimated tax payable by the installment payer for the year of income at the time of the installment;

B is the number of installments remaining for the year of income including the current installment; and

C is the sum of any income tax paid during the year of income, but prior to the due date for payment of the installment, by the person by previous installment, single installments and non-final withholding taxes (Section88(3)).

However, taxpayers with estimated tax payable for a year of income of TZS 50,000 or less are not required to pay taxes in installments (Section 88(4)).

Additionally, resident taxpayers engaged in agricultural business make no payments in the 1st and 2nd installments but in the 3rd installment pay 75% of estimated tax payable and the balance payable in the 4th installment.

Therefore, when the estimated tax payable is accurately estimated, the final tax liabilities after deducting previously paid taxes by way of installments and withholding may be small.

Example

Carter Ltd whose accounting period ends on 31 December each year estimated that in 2013 it was going to make a total income of TZS 20,000,000. After filing the statement of estimated tax payable on time and paying the first and second installment, the company changed the estimated taxable income to TZS 30,000,000 and also paid non-final withholding taxes amount to TZS 1,000,000.

Required:

If the tax rate was 30%, estimate the amount that was paid in the 1st, 2nd, 3rd and 4th installment and state the due date of each installment.

Answer

i] The due date of the **first installment** will be on or before 31 March 2013 and tax payable along with filingthe statement of estimated taxes would be TZS, given by:

$$\frac{\mathbf{A - C}}{\mathbf{B}}$$

A is the estimated tax payable by the installment payer for the year of income at the time of the installment = TZS6,000,000

B is the number of installments remaining for the year of income including the current installment = 4 installments; and

C is the sum of any income tax paid during the year of income, but prior to the due date for payment of the installment, by the person by previous installment, single installments and non-final withholding taxes (Section 88(3)) = Nil

Therefore the first installment amount would be

$$\frac{\mathbf{TZS\ 6{,}000{,}000 - 0}}{\mathbf{4}}$$

= TZS 1,500,000.

ii] In the **second installment**
A = TZS6,000,000,

B = 3 installments

C = TZS1,500,000; the amount paid in the first installment

Therefore the amount of the second installment payable on or before 30 June 2013 would be

$$\frac{\mathbf{TZS\ 6{,}000{,}000 – 1{,}500{,}000}}{\mathbf{3}}$$

=TZS1,500,000

iii] After revision of the estimated amount the value of
A = TZS9,000,000,

C = TZS4,000,000 from (TZS1,500,000 + TZS1,500,000 + TZS1,000,000) i.e. two installments and taxes paid at the source, and

B = 2 installments.

Therefore the amount of the **third installment** payable on or before 30 September 2013is

$$\frac{\textbf{TZS 9,000,000– 4,000,000}}{\textbf{2}}$$

= TZS 2,500,000.

iv] While in the last installment the value of
A = TZS9,000,000,

B = 1 installment and

C = TZS6,500,000 from TZS1,500,000 + TZS1,500,000 + TZS1,000,000 + 2,500,000.

Therefore the amount of the **last installment** payable on or before 31 December 2013would be

$$\frac{\textbf{TZS 9,000,000– 6,500,000}}{\textbf{4}}$$

= TZS2,500,000

Example

Halogen Ltd whose accounting period ends on 31 December each year estimated that in 2013 it was going to make a total income of TZS20,000,000.

After filing the statement of estimated tax payable on time and paying the 3rd installment, the company changed the estimated taxable income to 30,000,000.

Required:

If the tax rate was 30% and the company deals with agriculture business, estimate the amount that was paid in the 1st, 2nd, 3rd and 4th installment and state the due date of each installment.

Answer

i] For agriculture businesses the first and second installments are all zero
ii] The amount of third installment would be 75% of TZS6,000,000 =TZS4,500,000 payable on 30 September 2013.
iii] The fourth installment includes all the remaining estimated tax payable of TZS4,500,000 i.e. TZS1,500,000 from original estimate plus TZS3,000,000 for the extra revised estimate. Therefore TZS 4,500,000 should be payable on 31 December 2013.

2.1 Statement of estimated tax payable

The statement of estimated tax payable is a provisional return which a taxpayer is required to complete and file to the Commissioner within three months from the beginning of the year of income (which for individuals shall be the calendar year) (Section 89(1)).

These statements include the following information:

- Estimation of the person's chargeable income for the year of income from each employment, business and investment and the source of that income and the person's total income for the year of income and the income tax to become payable with respect to that income;

- In the case of a domestic permanent establishment of a non-resident person, the permanent establishment's repatriated income for the year of income and the income tax to become payable with respect to that income;
- Estimated tax payable for the year and any foreign tax relief which will be claimed by the person, and be signed by the person stating whether to the best of their knowledge and belief the estimate is true and correct; and have attached to it any other information that the Commissioner may

  prescribe.

2.2 Revision of income estimate
An installment payer's estimate shall remain in force unless unless the person files with the Commissioner a revised estimate.

This can result in the consequence that all installments are based on an estimate that has not been corrected during the year although the circumstances of the estimate have changed over the time. For example, the taxpayer estimated a profit as the basis for his calculation of income tax that proved to be too low as he could see some months later. If the taxpayer would in such case not adjust his estimation of income and tax he would have to pay a final tax liability considerably exceeding the amounts of his installments paid would arise. This could result in a heavy interest. In order to avoid such a situation a taxpayer is well advised to scrutinize on the due dates for the payments of his second and third installment whether his first estimate is still valid or needs to be adjusted by, for example, taking into account an economic development that turned out to be more positive than originally anticipated

2.3 Single installment
The Income Tax Act, Cap 332 requires a person who derives a gain from the realisation of an interest in land or buildings situated in the United Republic, shares or securities held in resident entity to pay income tax by way of single instalment (Section 90(1)).

The single instalment tax rate for resident person is 10% of the gain, and for non-resident taxpayers is 20% of the gain. These taxes must be paid before transfer of ownership documents and therefore before the titles are transferred from one person to another. The Registrar of Titles shall not register such a transfer without the production of a certificate from TRA certifying that the single instalment has been paid or is not payable.

In addition to the single instalment at the time of realisation of investment assets, taxpayers involved in the following businesses pay single instalment at 5% of the gross payment (Section 90(5)):

a non-resident instalment taxpayer who receives a payment in conducting a business of land, sea or air transport operator or chatterer

where no part of the above business is conducted through permanent establishment of the person situated in the United Republic

and the payment is received in respect of; the carriage of passengers who embark or cargo, mail or other moveable tangible assets that are embarked in the United Republic, other than as a result of transhipment;

or rental of containers and related equipment which are supplementary or incidental to carriage of

transportation businesses (Section 90(3)).

These payments must be made before the ship, vehicle or aircraft is cleared for customs purposes (Section

90(6)). The vehicle, ship or aircraft in respect of which the payment shall be received shall not be permitted to clear customs and leave the United Republic unless a tax certificate has been issued by the Commissioner showing that the single instalment has been paid.

Exemptions

The following are excluded from capital gains and hence exempt from single instalment payment:

- If the residence has been owned continuously by the individual for three years or more and lived in by the individual continuously or intermittently for a total of three years or more; and the interest was realised for a gain of not more than shillings 15,000,000. If he makes a gain of more than Tshs15 million, then he will have to reduce the gain by Tshs15 million (i.e. the excess of Tshs15 million will be taxed).
- An interest in land held by an individual that has market value of less than shillings 10,000,000 at the time it is realised and has been used for agricultural purposes for at least two of the three years prior to realisation.
- Payments received in respect of carriage of fish by a foreign aircraft are not subject to a single instalment payment (Section 90(4)).

An instalment payer shall be entitled to tax credit for a year of income of an amount equal to the income tax paid by way of single instalment for the year of income

3. Tax Payment Procedures By Return

The Income Tax Act requires a taxpayer to file a final tax return to TRA. Filing a return means making a statement to TRA's Domestic Revenue Department of the income sources and the tax a person is supposed to pay under the law. A return must be filed with supporting documents to verify the authenticity of the statement in case the TRA audits or investigates the return.

Unlike the statement of estimated tax payable, which is a provisional return based on estimation, the final return of income is based on actual performance of taxpayers. Returns of income are historical as they show the true financial performance of a person and must be accompanied by audited financial statements. Similar to the statements of estimated income, the returns of income are based on self-assessment.

3.1 Contents of the return of income (ROI)

A return of income of a person for a year of income shall specify:

- the person's chargeable income for the year of income from each employment, business and investment and the source of that income;
- the person's total income for the year of income and the income tax payable with respect to that income under Section 4(1)(a);
- in the case of a domestic permanent establishment of a non-resident person, the permanent establishment's repatriated income for the year of income and the income tax payable with respect to that income.
- any income tax paid by the person for the year of income by withholding, instalment or assessment for which a tax credit is available
- the amount of income tax payable after taking tax credit
- any other information that the Commissioner may prescribe

In addition, the return should include a declaration that the return is complete and accurate, be signed by the person and a Certified Public Accountant in Public Practice (CPA-PP) when the CPA-PP helps taxpayers in its preparation.

Also the taxpayer should attach any withholding certificates supplied to the person with respect to payments derived by the person during the year of income, any statement provided to the person from the CPA-PP; and any other information that the Commissioner may prescribe. Finally, returns on income of corporations should be prepared or certified by a certified public accountant in public practice.

3.2 Persons liable to file return of income (ROI)

Actually, all taxpayers are required to file a return on income except a resident individual who has no income tax payable or whose income for the year of income consists exclusively from (either or both sources):

- income from any employment where the employer withholds 'Pay As You Earn' tax or
- gains from realisation of assets where taxes are paid in the form of a single instalment (Section 92).
- Also, a non-resident person without a domestic permanent establishment who has no income tax payable for the year of income or whose income tax payable for the year of income consists exclusively of gains from realisation of assets where taxes are paid in the form of a single instalment is not required to submit a return on income (Section 92).

3.3 Nil and excess tax credit returns

Unless a person is exempt from filling tax returns, a return on income must be filed on the due date even when one has no taxable income: that return is known as a nil tax return. On the other hand tax paid during the year may exceed the annual tax payable; in that case there will be a tax credit. The excess may be refunded within

45 days after the person claims the amount or may set off against any unpaid tax. In fact the claim must be made in writing within three years of the later of:

- the end of the year of income during which the events occurred that gave rise to the payment of the excess; or
- the date on which the excess was paid.

3.4 Due date of filling returns on income

The due date of filling returns on income is on or before the end of six months after the end of each year. Where a taxpayer fails or is not required to file a return of income for a year of income, then until such time as a return is filed, an assessment will be treated as made on the due date for filing the return.

However, the taxpayer may request extension of the time required to file tax returns to the Commissioner. The Commissioner might allow the extension which must not exceed 60 days from the original due date of the tax returns.

TRA has issued a calendar (TRA tax calendar) to remind taxpayers and stakeholders of the important dates of filing tax returns, making tax payments and other important events. This calendar should help in planning your tax affairs.

Example

Robots Ltd who has an accounting period ending 31 December each year, estimated that in 2013 it was going to make a total income of Tshs20,000,000 and paid estimated tax payable as required. Then, after the year end, the actual taxable income turned out to be Tshs30,000,000 and the tax rate was 30%.

Establish the due date of filing the return on income.

Answer

Returns on income are filed on or before 6 months after the year end, so the due date of filing ROI is on or before 30 June 2014.

Explain concept tax assessments and notice of assessment; identify documents required to be maintained by Taxpayers and describe the "EFD" system, its benefits and the possible revenue risks involved.

[Learning outcome d, e, and f]

4. The Concept Of Tax Assessments And Notice Of Assessment

4.1 Tax assessments

Tax assessments involve calculating taxable income and application of tax rates on the taxable income to determine tax payable for the year and deduction of tax credit from tax payable for the year to determine tax payable on assessment.

Normally, there are five categories of assessments: self-assessment, jeopardy assessment and adjusted assessment.

(i) **Self- assessment**

This occurs when taxpayers estimate their tax payable themselves or with the help of tax consultants and file return on income as required i.e. not later than 6 months after the end of each year of income.

(ii) ***Provision assessment***

When a taxpayer has furnished a statement of estimated tax payable he is automatically deemed to have been provisionally assessed on the basis of estimates contained in such statement.

(iii) ***Best judgment assessment***

If the commissioner is not satisfied that the return of income is correct and complete, he has the power to estimate income of the tax payer to the best of his judgment and make an assessment accordingly.

(iv) ***Jeopardy assessment***

This happens when the Commissioner General requires a person to file return on income by the date specified in the notice disregarding the normal date of filing tax returns. The Commissioner General may do this:

(a) when a person becomes bankrupt,
(b) when a business is wound-up or goes into liquidation,
(c) when a business is about to leave the United Republic indefinitely,
(d) when a business is otherwise about to cease activity in the United Republic;

4.2 Notice of assessment

The Commissioner General may make jeopardy assessment or interest and penalty assessment. Where the Commissioner General makes any of these assessments she is required serve a written notice of assessment on the person. The notice of assessment should state the following.

(i) The name of tax payer and TIN
(ii) The Commissioner's assessment of the tax payable
(iii) The manner in which the assessment of the income tax payable is calculated
(iv) The reasons why the Commissioner has made the assessment
(v) The date by which the tax payable on the assessment must be paid
(vi) The time, place, and manner of objecting to the assessment

Filing / service of notice of assessment

Notice of assessment **shall** be considered to have been received in the following circumstances-

(a) in the case of service by handing to a person or leaving at a place, at the time of handing or leaving

(b) in the case of service by registered post, at the time the document is delivered or the person is informed that the document awaits the person
(c) in the case of other service by post to an address within the United Republic, ten days after posting; and
(d) in the case of other service by post to an address outside the United Republic, the time at which the document would normally be delivered in the ordinary course of post.

An electronic document is considered to be served on a person by the CG under a tax law when a document registration number is created and the document can be accessed by using the person's authentication code

5. Documents Required To Be Maintained By Taxpayers

Section 35 of the Tax Administration Act, 2015 states that, every taxable or liable person shall, within the United Republic, maintain documents in paper or electronic form which-

(a) contain information to be provided or filed with the Commissioner General under any tax law;
(b) enable an accurate determination of tax payable under any tax law;

TRA Practice Note no 06/2004 requires the following records and documents to be maintained

(i) The books of accounts written up at regular intervals. Appropriate entries for each transaction should be recorded as soon as possible (in any case not later than 30 days after the transaction).
(ii) Supporting documents such as invoices, bank statements, pay-in slips, cheque buts, and receipts for payments, payroll records and copies of receipts issued should be retained.
(iii) Where any person receives a payment of an amount of one thousand shillings or more from the sale of goods or performance of service other than as an employee, the person shall issue a receipt to the person making the payment. The receipts must be serially numbered.
(iv) A valuation of the stock in trade or work in progress should be made at the end of each accounting period and the appropriate records maintained.

5.1 Official language for documents and records

Section 29 of the Tax Administration Act, 2015 provides that documents and records should be written in the official language. The official languages for the purposes of tax administration are both Kiswahili and English language. If the records are written in a language other than the official language, a written translation is to be provided, at the expense of the entity when requested by the Commissioner

5.2 Period for keeping records

The documents shall be retained for a period of five years from the relevant date or for a further period as prescribed in the tax law
However, for a person who:-

(i) files an objection or appeal, all documents relevant to the matter in dispute shall be retained until the matter is finally determined and the decision is executed;
(ii) makes an application to the Commissioner General, all documents relevant to the application shall be retained until the application is finally decided;
(iii) applies for a refund of tax, all documents relevant to calculation of the refund shall be retained until the refund is made; and
(iv) has received notice of an investigation or audit by the Commissioner General, all documents relevant to the investigation or audit shall be retained until the Commissioner General notifies the person in writing that the investigation or audit is finalised

6. The "EFD" System, Its Benefits And The Possible Revenue Risks Involved

As part of improvement of tax administration and tax revenue through proper accounting records, taxable persons are required to issue electronic fiscal receipts through Electronic Fiscal Devices (EFDs) (The Value Added Tax (Electronic Fiscal Device) Regulation, 2010). The electronic fiscal devices are normally connected through a GPRS modem at Tanzania Revenue Authority enabling recording of all sales transactions at the authority servers.

The EFDs must be acquired by the taxable persons but the costs of first batch of the EFDs are provided by the government for free, where taxpayers are allowed to deduct the costs as input taxes (Value Added tax (Electronic Fiscal Devices) Section 28).

The authority categorizes EFDs into:

1. Electronic Tax Register (ETR): the device is used by retail businesses that issue receipts manually,
2. Electronic Fiscal Printer (EFP): the device is used by computerized retail outlets. It is connected to a computer network and stores sale transactions or details made in its fiscal memory,
3. Electronic Signature Device (ESD): the device is designed to authenticate by signing any personal computer (PC) produced financial document such as tax invoice. The device uses a special computer program to generate a unique number (Signature).

Definitions

'**Electronic Fiscal Device (EFD)**' means a machine designed for use in business for efficient management controls in areas of sales analysis and stock control system and which conforms to the requirements specified by the laws. Tanzania Revenue Authority, 2013

'**First batch**' is the first purchase of order of electronic fiscal devices by taxable persons not applicable of the subsequent purchase of the electronic fiscal devices. Value Added Tax (EFDs) Section 28(3)

Each EFD has the following features:

1. First, they have viable fiscal seals to prevent tampering with the EFDs, when any sign of tampering with seals is seen it should be promptly reported to the authority.
2. Second, all have fiscal memory to store data; once data is entered it cannot be altered, but when an error occurs a person should issue another fiscal receipt and make the error adjustment at the end of the month after providing the proof of the error.
3. Third, all have unique serial number within the fiscal memory and the number identifies the owner of an electronic fiscal device.
4. Fourth, all have unique specifications followed when operating their software and hardware.

The EFD offer the following benefits to both taxable persons and the authority:

1. Computerizing the tax auditing process as data are stored electronic; this results into spending little time on auditing using computers and software auditing techniques even on larger data.
2. With introduction of electronic signature devices, the authorities and taxable persons use less time when issuing tax documents as electronic fiscal receipts.
3. The availability of accounting records at taxable persons' place of businesses; EFDs and the authority servers may reduce disputes between officers and taxable persons during audit as the evidence can be easily compared. Furthermore, the EFDs issue automatic self-enforcing Z report daily after every 24 hours;
4. The Z-report is obtained by pressing a button on the device at the end of each business day; the report reports all transactions of the day and their total.
5. It might reduce tax evasion resulting from falsification of accounting records when the EFDs are used by taxable persons, because the data are irreversible.
6. They have in-built fiscal memory which cannot be erased by mechanical, chemical or electromagnetic interferences.

7. Transmits tax information to TRA system automatically. This will save a lot of administrative time and costs.
8. They issue fiscal receipt/invoice which is uniquely identifiable, enabling taxpayers to comply with tax laws.
9. They have at least 48 hours power backup, and it can use external battery in areas with no electricity supply. They therefore can work where there are frequent power cuts.
10. They save configured data and records on permanent fiscal memory automatically;
11. They have tax memory capacity that stores data for at least 5 years, which is a benefit to taxpayers because they are required to keep records at least for 5 years.

4 Answers to Test Yourself

Self-Examination Questions

Question 1

Robots and Assembler Design Makers Ltd whose accounting period ends on 31 December each year estimated that in 2013 it was going to make a total income of TZS20,000,000.

If after filing the statement of estimated tax payable on time and paying the first and second installment, the company changed the estimated taxable income to TZS10,000,000 and also paid non-final withholding taxes amounting to TZS1,000,000.

Required:

If the tax rate was 30%, estimate the amount that were paid in the 1st, 2nd, 3rd and 4th installment and state the due date of each installment.

Question 2

Samaha Enterprises Limited file with the Commissioner its provisional return (statement of estimated tax payable) on 30th August 2011 in respect of the year of income starting July 1, 2011. The return indicates estimated tax payable of TZS 45,000,000. During that year of income, the company paid or was charged the following taxes:

Date	Details	TZS
September 20, 2011	Withholding Tax – Dividend from non-resident company	2,000,000
November 3, 2011	Single Instalment Tax – Realization of shares	500,000
May 4, 2012	Withholding Tax – Rent from another company	4,000,000

Required:

Determine the amount of tax paid in each instalment.

Question 3

Mama Africa Company Ltd is a company conducting business and investment. The company lodged statement of estimated income for 2014/2015 year of income on 28th February 2015 which showed a total income of TZS.300 million. On 31st December 2015 the Company lodged the returns for the year of income worth (total income) TZS.400 million.

Company paid non final withholding tax on the following dates:-

1. 20th March 2014 paid TZS.2 million.
2. 20th July 2014 paid TZS.3 million.
3. 20th October 2014 paid TZS.3 million
4. 20th December 2014 paid TZS.4 million.
5. 20th January 2015 paid TZS.2 million.

Note that: Year of income ends on 30th June every year and banking lending rate is 7% per month. **Required:**

For the year of income 2014/2015:-

Compute tax to be paid in 3rd and 4th instalments

Question 4

(a) Explain four possible reasons why the Tanzania government set deadlines for filling return and or paying taxes.

(b) A person with a year of income starting 1st July 2014 ending 30th June 2015, his estimated income tax for the year of income is Tshs.13,000,000. During the first two months of the year of income, he paid Tshs.1,000,000 income taxes under non-final withholding payments.

Required:

Compute the amount for each installment.

Question 5

(c) Differentiate between final returns and statement of estimated tax returns as per Income Tax Act, Cap 332. Describe the contents of such returns.

(d) Explain the implication of the various tax assessments admissible by the Commissioner General for income tax.

Answers to Self-Assessment Questions

Answer to SEQ 1

(i) The due date of the first installment will be on or before 31 March 2013 and tax payable along with filing the statement of estimated taxes would be given by:

[A - C]/B

Where **A =** TZS6,000,000, **B =** 4 installments and **C =** Nil.

Therefore the installment amount would 6,000,000/4= TZS15,000,000

(ii) In the second installment the value A would be TZS6,000,000, C, TZS1,500,000 amount paid in the first installment and value of B is 3 installments. Therefore the amount of the second installment would be

(TZS6,000,000 - TZS1,500,000)/3= TZS1,500,000.

The amount was payable on or before 30 June 2013.

(iii) After revision of the estimated amount value of A changed to TZS3,000,000, C to TZS4,000,000 from(TZS1,500,000 + TZS1,500,000 + TZS1,000,000) i.e. two installments and taxes paid at the source, andvalue of B is 2 installments. Therefore the amount of third installment was (TZS3,000,000 -TZS4,000,000)/2= TZS500,000. Therefore nothing will be payable on or before 30 September 2013.

(iv) While in the last installment the value of A would be TZS3,000,000, value of B would be 1 installment and the value of C would be TZS4,000,000 from TZS1,500,000 + TZS1,500,000 + TZS1,000,000. There fore the amount of the last installment would be (TZS3,000,000 –TZS4,000,000)/1= TZS-500,000. Again nothing is payable on or before 31 December 2014.

Answer to SEQ 2

There will be four instalments the amounts of which are as follows:

$$\text{Installment Amount} = \frac{\text{A} - \text{C}}{\text{B}}$$

The first instalment, 30th September 2011

A = TZS 45,000,000, B = 4, and C = TZS 2,000,000

$$\text{First Installment Amount} = \frac{45{,}000{,}000 - 2{,}000{,}000}{4}$$

$$\text{First Installment Amount} = \text{ TZS } 10{,}750{,}000$$

The second instalment, 31st December 2011:

A = TZS 45,000,000, B = 3, C = 2,000,000 + 10,500,000 + 500,000 = TZS 13,250,000

$$\text{Second Installment Amount} = \frac{45{,}000{,}000 - 13{,}250{,}000}{3}$$

$$\text{Second Installment Amount} = \text{ TZS } 10{,}583{,}333$$

The third instalment, 31st March 2012

A = 45,000,000; B = 2; C = 2,000,000 + 500,000 + 10,750,000 + 10,583,333 = TZS 23,833,333

$$\text{Third Installment Amount} = \frac{45{,}000{,}000 - 23{,}833{,}333}{2}$$

$$\text{Third Installment Amount} = \text{ TZS } 10{,}583{,}333$$

The fourth instalment, 30th June 2012

A = 45,000,000; B = 1;

C = 2,000,000 + 500,000 + 10,750,000 + 10,583,333 + 10,583,333 = TZS 38,416,667

$$Fourth\ Installment\ Amount = \frac{45{,}000{,}000 - 38{,}416{,}667}{1}$$

$$\text{Fourth Installment Amount} = \text{ TZS } 6{,}583{,}333$$

Answer to SEQ 3

$$\mathbf{I = \frac{[A - C]}{B}}$$

Where-

A is the estimated tax payable by the installment payer for the year of income at the time of the installment under section 89;

B is the number of installments remaining for the year of income including the current installment; and

C is the sum of any -

(i) income tax paid during the year of income, but prior to the due d ate for payment of the installment, by the person by previous installment under this section; or section 90;

(ii) income tax withheld under Subdivision A of Division II during the year of income, but prior to the due date for payment of the installment, from payments received by the person that are included in calculating the person's income for the year of income; and

(iii) income tax paid in accordance with section 83(3) or (4) with respect to a payment of the kind referred to in paragraph (b) that shall be paid to the Commissioner by the withholding agent or the withholder during the year of income but prior to the due date for payment of the installment.

I = Installment.

(i) 3^{RD} Installment; 31 March 2015

A 300m*30%=90m TZS

B=2

C=3 + 3 + 4 + 2 = 12m

3^{RD} Installment $= \frac{90m-12m}{2}$

= TZS 39 m

4^{TH} Installment; 30 June 2015

A=300m*30%=90m TZS

B=1

C=12m+39m=51m

4^{TH} Installment= $\frac{90m-51m}{1}$

TZS 39 m

Answer to SEQ 4

(a) **Reasons**

(i) Enables entities to plan when to undertake the work on their tax assessment and to accommodate the cash flow impact.

(ii) Enables the tax authorities to plan their work and for governments to prepare their budgets more easily.

(iii) Provides reference points for the tax authorities to enforce disclosure and payment of tax and to determine the amounts of any penalties that may arise.

(iv) Prevent entities from being tempted to spend personal income tax and social security contributions deducted at source from employees pay. The longer monies remain uncollected, the greater the risk that employers will use the funds for other purposes.

(b) **To compute the amount for each installment**

(i) The amount of first installment is

$$\frac{13{,}000{,}000-1{,}000{,}000}{4} = \frac{Shs.12{,}000{,}000}{4} = Tshs.3{,}000{,}000$$

(ii) The amount of 2nd installment is

$$\frac{13{,}000{,}000-(3{,}000{,}000+1{,}000{,}000)}{3} = Tshs.3{,}000{,}000$$

(iii) The amount of 3rd installment is

$$\frac{13{,}000{,}000-(3{,}000{,}000+3{,}000{,}000+1{,}000{,}000)}{2} = Tshs.3{,}000{,}000$$

(iv) The amount of 4th installment is

$$\frac{13{,}000{,}000-(3{,}000{,}000+3{,}000{,}000+3{,}000{,}000+1{,}000{,}000)}{1} = Tshs.3{,}000{,}000$$

Answer to SEQ 5

(c) A final return of income is a statement written by the tax payer and submitted to the Commissioner for income tax. It must be submitted within three months after the end of accounting period/year of income vs Statement of Estimated Income Tax.
The final return contains:

- All income derived in the year of income
- All expenses incurred during the year of income
- Taxable income
- Tax liability/payable
- And any other information the commissioner may require.

- The term assessment means:
  - ❖ Computation of income of a taxpayer; or
  - ❖ Determination of the amount of income tax payable; or
  - ❖ Entire procedure for imposing liability on the taxpayer as laid down in the Act.

Types of assessments

- Statement of estimated tax payable or Provisional assessment
- Self assessment
- Jeopardy or Accelerated assessment
- Adjusted assessment
- Best judgments assessment

Implication of assessments:

(i) Computation of the income assessable/taxable income;

(ii) Computation of the income-tax payable by taxpayer on the basis of computed income in (i) and the appropriate rate; and

To issue a notice of assessment intimating the fact of assessment made on him(this notice shows details of income assessed, gross tax payable, the reliefs, if any, given the set-off or credit of tax deducted at source or already paid, net amount of tax payable and the due date of payment)

SECTION E

NON-COMPLIANCE WITH INCOME TAX ACT

E1

STUDY GUIDE E1: NON-COMPLIANCE WITH INCOME TAX ACT

Get Through Intro

While complying with the Tax laws, following the due dates is very important as any delay in filing returns and paying tax can lead to heavy penalties and interest. This Study Guide discusses consequences of not complying with the Income Tax Act, Cap 332

As a tax consultant, you will need this information to advice clients on how to minimize penalties. A thorough understanding of this topic is important for your examination, as well as in your professional life.

Learning Outcomes

(a) Calculate Interest for Under Estimating Tax Payable.
(b) Calculate Interest for failing to pay tax.
(c) Calculate the penalty for failing to maintaining documents.
(d) Calculate penalty for failing to file tax return.
(e) State the penalty for making false or misleading statements.
(f) State the offences from non-compliance.
(g) Describe Procedures to Recover Tax from Taxpayer.

Calculate Interest for Under Estimating Tax Payable; calculate Interest for failing to pay tax; and calculate the penalty for failing to maintaining documents.

[Learning Outcome a, b, and c]

1. **Computation of Interest for Under Estimating Tax Payable.**

   Under s.75 of the Tax Administration Act, if estimated income tax payable for a year of income is less than 80% of correct amount of final tax), the installment payer (taxpayer) shall be liable for interest for each month or part of a month (the period) from the date the first installment for the year of income is payable until the due date by which the person must file a return of income for that year of income. The rate of interest is the statutory rate compounded monthly on the difference between

   (a) the total amount of income that would have been paid by way of installments during the year of income to the start of the period had the person's estimate or revised estimate equaled the correct amount; over

   (b) the amount of income tax paid by installments during the year of income to the start of the period.".

The formula for calculating interest for under-estimation is given by:

$I = P\,[(1- R)^{N} – 1]$,

where;

I = Interest charge,

P = difference between actual tax payable and estimated tax paid

R = monthly statutory rate and

N = number of periods from the first instalment up to the day the return on income is supposed to be filed.

Example

MaduhuLtdwhoseaccountingperiodendson31Decembereachyearestimatedthatin2017itwasgoingto makeatotalincomeofTshs20,000,000.Thecompanyfiledthestatementofestimatedtaxpayableon5May2017a ndreturnonincomeon 30August 2018 showing tax payable of Tshs9,000,000butallinstalmentswere paid on time and the tax payable on assessment was paid on 30August 2018.

Required

Ifthetaxratewas30%andstatutoryratewas10%, determine whether there is under-estimation of tax payable in instalments.

If yes compute the interest for under estimation.

Answer

If estimated Income tax payable is less than 80% of the actual tax shown in the return; there is underestimation.

Solution

- 80% of correct tax i.e. 80% xTshs 9,000,000 = Tshs. 7,200,000.
- Income tax paid by installment = 30% x Tshs20,000,000= Tshs6,000,000
- Excess = Tshs 9,000,000 – Tshs 6,000,000 = Tshs. 3,000,000
- Date of 1st instalment = 31/3/2017
- Date of filing return of income 30/6/2015,
- Duration = 15 months (periods)
- BOT statutory rate 10%

Interest:
PV = Tshs. 3,000,000
n = 15 months
i = 15%/12 months
$I = 3,000,000*(1+15\%/_{12})^{15}-1$
=Tshs614,487

2. Calculate Interest for failing to pay tax.

Under s.75 of the Tax Administration Act, 2015, taxpayers who fail to pay tax on or before the date on which the tax is payable are liable for interest for each month or part ofamonthforwhichanyofthetaxis**outstanding**calculatedasthestatutoryrate, compounded monthly, applied to the amount outstanding at the start of the period

The formula for calculating interest is given by: $I = P [(1 + R)^{N}-1]$,

Where I = Interest charge

P = Unpaid taxes

R = monthly interest charge rate

N = number of periods in which taxes were unpaid.

MaluluLtdwhoseaccountingperiodends31 Decembereachyearestimatedthatin2013it was going to make total income of Tshs20,000,000.

The company filed the statement ofestimatedtaxpayableon5May2013and paid the first instalment on the same date

Required:

If the tax rate was 30% and statutory rate was 15%, compute the interest for failure to pay tax on time.

Workings:

Estimated tax payable 30% x Tshs20,000,000= Tshs6,000,000,

The first instalment is Tshs1,500,000.

Interest for failure to pay tax = $P [(1 + R)^{N} – 1]$, where

P = unpaid taxes i.e. Tshs1,500,000,

R = monthly statutory rate, i.e. (15%)/12=1.25%and

N = number of periods in which failure continued = 2months.

Therefore the interest is Tshs37,734.

3. Computation of penalty for failing to maintaining documents.

A person who fails to maintain proper documents as required by a tax law is liable for a penalty for each month or part of a month during which the failure continues. The penalty shall, in the case of an individual, be 1 currency point or, in the case of a body corporate 10 currency points. **(s. 77 of the Tax administration Act. 2015)**
(1 point currency is equivalent to Tshs 15,000)

Example

During the year of income ended 31 December 2015, KCB Ltd failed to maintain proper documents and filed a return of income showing business income of Tshs 200,000,000 on which tax of 60,000,000 was paid by the due date. On the audit that was carried out, it was established that the company income was supposed to be Tshs 300,000,000 had a proper documents been kept.

Required:

Compute penalties if any under section 77 of the Tax Administration Act, 2015, assume the failure to maintain the documents continued for all 12 months of the year of income.

Answer

Penalty per month=10 Currency points = (Tshs 15,000×10) =Tshs 150,000

Total Penalty = 150,000 × 12 Months= Tshs 1,800,000

Calculate penalty for failing to file tax return; state the penalty for making false or misleading statements; state the offences from non-compliance; and describe Procedures to Recover Tax from Taxpayer.

[Learning Outcome d, e, f and g]

4. Computation Penalty For Failing To File Tax Return

Under s.78 of the Tax Administration Act, 2015,a person who fails to file a tax return (provisional and final return) or pay tax on due date as required by a tax law is liable for a penalty for each month or part of a month during which the failure continues. The penalty is higher of:-

(i) 2.5% of unpaid tax at starts of the month and

(ii) 5 currency points and 15 currency points per month for individual and entity respectively.
(1 point currency is equivalent to Tshs 15,000)

5. State the penalty for making false or misleading statements

Section 79 of the Tax Administration Act, 2015 provides that, a person is liable for a penalty if he-

(a) makes a statement to a tax officer which is false or misleading in a material particular; or

(b) omits to include in the statement made to the tax officer, any matter or thing without which the statement is misleading in a material particular

The penalty shall be

(a) where the statement or omission is made without reasonable excuse, fifty percent of the tax shortfall; or

(b) where the statement or omission is made knowingly or recklessly, seventy five percent of the tax shortfall.

The penalty will be-

(a) increased by ten percent for the second or subsequent application of this section to the person; and

(b) reduced by ten percent if the person voluntarily discloses the statement prior to its discovery by the tax officer or the next tax audit of the person

6. State The Offences From Non-Compliance

In a self-assessment system, it is important for various offences to be known so that taxpayers organize their affairs to ensure maximum compliance.

Offences under tax administration act, 2015

1. Offence of failure to comply with Tax Administration Act,2015	
A person who fails to comply with a provision of the provisions of Tax Administration Act commits an offence and shall be liable, on conviction (a) where the failure results or, if undetected may have resulted in an underpayment of tax in an amount exceeding 50 currency points, to a fine of not less than 20 currency points and not more than 50 currency points, or to imprisonment for a term of not more than six months, or to both; and (b) in any other case, to a fine of not less than 10 currency points and not more than 20 currency points.	**Section 82**
2. Offence for failing to pay tax	
Any person who fails to pay any tax on, or before the date on which the tax is payable commits an offence and shall be liable on conviction- (a) where the failure is to pay tax in excess of 50 currency points, to a fine of not less than 25 currency points and not more than 100 currency points or imprisonment for a term of not less than three months and not more than one year, or to both; and (b) in any other case, to a fine of not less than 10 currency points and not more than 25 currency points or imprisonment for a term of not less than one month and not more than three months, or to both.	**Section 83**

3. Offence for making or using false or misleading statements or documents	
Any person who, in any matter relating to the excise duty any tax laws set out under the Part A of the First Schedule to the Tanzania Revenue Authority Act; (a) makes any entry of any building, room, place, or item of plant, which is false or incorrect in any material particular; (b) makes or causes to be made any declaration, certificate, application, return, account, or other documents, which is false or incorrect in any material particular; (c) when required to answer any question put to that person by an officer, refuses to answer such question or makes any false or incorrect statement in reply thereto; (d) is in any way involved in any fraudulent evasion of the payment of any tax; (e) obtains any remission, rebate or refund of tax which he is not entitled to obtain; (f) makes any false statement or false representation in order to obtain any remission, rebate, refund of tax or any tax benefit (g) acquires possession of, keeps, conceals, removes or in any way deals with, any excisable goods or any taxable goods which have been manufactured or supplied without payment of the full tax; (h) counterfeits or in any way falsifies or uses when counterfeited or in any way falsified, any document required or issued by or used for the purpose of the tax; (i) omits or fails to make or cause to be made any declaration, certificate, application, return, account, or other documents, which is true or correct in any material particular; or (j) acquires, possess, keeps or conceals, or in any way deals with, any fiscal receipt or fiscal document which is false or incorrect in any material particular; Commits an offence and upon conviction is liable for payment of twice of the amount of the tax evaded.	**Section 84**
4. Offence for impeding tax administration	**Section 85**
A person who impedes or attempts to impede the administration of a tax law commits an offence. Upon conviction- (a) where the offence involves fraud or undue force, to a fine of twice the amount sought to be evaded or recovered or 200 currency points,	

whichever is greater or imprisonment for a term of not less than two years and not more than four years, or to both; and (b) in any other case, to a fine of not less than 10 currency points and not more than 200 currency points or imprisonment for a term of not more than two years, or to both.	
5. Offence for failing to use electronic fiscal device	**Section 86**
A person who: (a) fails to acquire and use an electronic fiscal device upon commencement of business operations or expiry of the period specified by the Commissioner; (b) fails to issue fiscal receipt or fiscal invoice upon receiving payment for sale of goods or service (c) issues a fiscal receipt or fiscal invoice that is false or incorrect in any material particulars; (d) uses electronic fiscal device in any manner that misleads the system or the Commissioner; (e) tempers with or causes electronic fiscal device to work improperly or in a manner that does not give a correct or true document, Commits an offence and shall be liable on conviction to a fine not less than 200 currency points and not more than 300 currency points or to imprisonment for a term not exceeding three years or to both. **6. Offences authorized and unauthorised person**	
1. A person authorized by the Authority to perform any function or carryon any duty under a tax law commits an offence where that person- (a) directly or indirectly asks for or takes in connection with the person's duties, any payment or reward or promise or security for any such payment or reward, not being a payment or reward that the person is lawfully entitled to receive; or (b) agrees to, permits, conceals, connives at or acquiesces in any act or thing whereby the Government is or may be defrauded with respect to any matter under a tax law, including the payment of tax. 2. A person who is not authorized by the Authority commits an offence if that person- (a) collects or attempts to collect an amount of tax payable under a tax law or an amount which that person describes as tax; or (b) makes representations with the intent to make another person to believe that, that person is a tax officer. A person who commits an offence under (1) or (2) shall be liable, on conviction, to a fine of not less than 200 currency points or imprisonment for a term of not less than twelve months and not more than five years, or to both.	**Section 87**

Offences by entities	**Section 88**
Where an entity has committed an offence under a tax law, every person who is a manager of the entity at the time of commission of that offence shall be treated to have committed that offence ,except where the manager has exercised the degree of care, diligence, and skill that would have been exercised by a reasonable person in preventing the commission of that offence **Penalty** Upon conviction a person is liable to a fine of not less than 200 currency points and not more than 300 currency points or to imprisonment for a term not exceeding three years or to both.	
Offence for aiding or abetting	**Section 89**
Any person who aids, abets, counsels or induces another person to commit an offence under a tax law commits an offence and shall be liable, on conviction,- (a) where the original offence involves a statement of the kind prescribed in section 84(1) and, if the inaccuracy of the statement were undetected, may have resulted in an underpayment of tax to a fine of not less than 100 and not more than 200 currency points, imprisonment for a term of not less than one year and not more than two years, or to both; (b) where the original offence involves inducing an authorised person to commit an offence under section 87, to a fine of not less than 200 currency points, or imprisomnent for a term of not less than twelve months and not more than five years, or to both; or (c) in any other case, to a fine of not less than 50 currency points and not more than 100 currency points, or to imprisonment for a term of not less than six months and not more than one year, or to both.	

7. Describe Procedures to Recover Tax from Taxpayer

Taxpayer may financially unable to pay their tax liabilities but more often times they simply refuse to pay their taxes. It may be necessary to compel/force payment. In order to reduce tax arrears regular collection measures are desirable. Various penalties as already been discussed do assist to compel the payment but they may not be adequate. Commissioner General has several other options to enforce tax collection.

Specific tax collection devices to compel tax payment –Section 59 to 69 of the Tax Administration Act, 2015

(a) Suit for unpaid tax

Tax that has not been paid when it is payable may be sued for and recovered in any court of competent jurisdiction by the Commissioner General acting in the Commissioner's official capacity. It is generally accepted principle that the tax due and payable by any person is a debt to the government and the Commissioner General is doing so on behalf of the government.

(b) Security for withholding tax

The Commissioner-General shall have a first claim over the assets before any distribution in liquidation or bankruptcy of a withholding agent is made

(c) Charge over assets

Where a taxpayer fails to pay tax on time, the Commissioner General may create a charge in favour of the Government over assets owned by that taxpayer .The assets of a taxpayer shall be charged to the extent of the unpaid tax, interest accruing and any costs of charge and sale. Generally the charge over an asset is like levying a distress upon the taxpayer’s goods and chattels. It is some sort of distrait.The charge of an asset comes to an end when the tax debtors has paid the tax to which the charge relates to the commissioner A charge will be released when the taxpayer pays in full the amounts of unpaid taxes ,interest accruing and any costs of charge and sale to the Commissioner General.

(d) Sale of charged assets

The provision requires charged assets to be sold at public auction.

The proceeds of sale shall be used to pay-

(a) the costs of charge and sale of the assets sold;

(b) the outstanding tax and interest accrued ; and

(c) any other unpaid tax.

Where there is any balance of money after making payment described above, such balance shall be paid to the taxpayer.

Where the sale proceeds are insufficient to pay in full the costs of charge and sale, the tax due and interest accrued with respect to that tax, the Commissioner General may proceed to collect the insufficiency with fresh actions.

(e) Restraint person

Where a person fails to pay tax on time and such person is likely to flee from the United Republic, the Commissioner General may, by notice in writing or any other means of official communication to the Director of Immigration Services, order the Director of Immigration Services to prevent **that** person from leaving the United Republic. The Director of Immigration Services shall, on receiving the notice, prevent the person from leaving the United Republic for a period of fourteen days from the date the notice is served. The Commissioner General shall, where the person pays the tax or arranges for payment in a manner satisfactory to him, withdraw the notice.

(f) Restraint of assets

Where the Commissioner General is satisfied that-

(a) the value added tax has not been paid in respect of the supply or import of goods;

(b) a vehicle contains any fuel on which road and fuel tolls has not been paid;

(c) transit charges have not been paid with respect to a foreign vehicle;

(d) Motor vehicle registration or transfer tax has not been paid with respect to a vehicle; or
(e) Any provision of the Excise (Management and Tariff) Act has been breached with respect to excisable goods

The Commissioner General may
(a) restrain the goods, vehicle, vessel or any other asset
(b) restrain and search any premises, place, vehicle, vessel or any other asset which he believes the goods, vessel or vehicle are located;
(c) mark, lock up or seal any building, room, place, receptacles or item of plant in any factory, exercisable goods, or materials in a factory

Recovery from third parties

(a) Liability of managers of entities

Where an entity fails to pay tax on time, a manager or a person who was the manager of that entity within a period of twelve months prior to the entity default shall be jointly and severally liable with the entity for payment of the tax. **Except** where the manager has exercised the degree of care, diligence, and skill that would have been exercised in preventing the failure to pay tax.

(b) Receivers

A person who has been appointed to be a receiver shall, sell sufficient assets that come into his's possession under the receivership to pay for any entity's tax due. The receiver shall, to the extent that he fails to set aside an amount as required, be personally liable to pay to the Commissioner General on account of the taxpayer's tax liability the amount that should have been set aside.

(c) Third party debtors and guarantors

Where a taxpayer fails to pay tax on time, the Commissioner General may serve on the third party debtor who owes money to that taxpayer a notice in writing requiring that person to pay the money to the Commissioner General.

The following shall be treated as money owed to a taxpayer-
(a) money currently owing or that may subsequently become owing to the taxpayer;
(b) money held or that may subsequently be held for or on account of the taxpayer;
(c) money held or that may subsequently be held on account of a third person for payment to the taxpayer; and
(d) money held by a person who has authority from a third person to pay the money to the taxpayer.

(d) Agents of non-residents

Where, a non-resident taxpayer fails to pay tax on time or the Commissioner General has good reasons to believe that a non-resident taxpayer shall not pay tax on time, the Commissioner General may, by notice in writing, require the agent who is in possession of an asset owned by the non-resident taxpayer to pay tax on behalf of that taxpayer.

Self -Test Examination Questions

Question 1

ABC Co. Ltd's main line of business is manufacturing. The company's 12 months accounting period runs from 1st September each year.For the year of income 20X6, the company furnished a statement of estimated income tax on 15st April 20X6, for the year of income of an income of Tshs 140 million.However on 16th June 20X6, the company paid the full income taxes shown on statement of estimated income tax payable for the year of income 20X6. On 20th May 20X7, the company furnished the return of income for the year declaring an income of Tshs 200 million.

Required: Calculate

i) Penalties for failing to file tax return if any payable under section 78 of the Tax administration Act, 2015.

ii) Interest payable on under-estimation of estimated tax under section 75 of the Tax administration Act, 2015.

iii) Compute interest for failing to pay tax (if any), under section 76 of the Tax administration Act, 2015.

BOT statutory rate 15%

Question 2

Muhidin & Co. Ltd is a company established in the United Republic of Tanzania since 1990s. Its accounting period starts on 1st October each year. During the year of income ended 30th September 2014, the company filed its statement of estimated tax payable on 28th February 2014 with taxable income amounting to TZS. 240,000,000/= and paid the 1st installment amount on that date while the 2nd and 3rd installments were paid on their respective due dates as per S.88 of the ITA (Cap. 332) (R.E. 2014). The company filed revised estimates with an income tax amounting to TZS.75,000,000 on 31st December 2014 and paid the amount due thereof. On 30th June 2015, the company filed its final tax return with taxable income of TZS. 300,000,000/=.

Required:

(i) What was the due date for filling the provisional returns for Muhidin & Co. Ltd as per S.89 of the ITA, Cap 332, (R.E. 2014)?

(ii) State the due date for filling the final return for Muhidin & Co. Ltd as per the provisions under the ITA, Cap. 332, (R.E. 2014).

(iii) Compute the amount of income tax paid by Muhidin & Co. Ltd on 1st installment and 4th installment.

(iv) Compute the amount of income tax paid by Muhidin & Co. Ltd on 30th June 2015 (ignore any interest and/or penalty thereof).

Ascertain the amount of penalty payable by Muhidin & Co. Ltd as per S.78 of the Tax Administration Act, 2015 (if any).

Question 3

Zuma Zuma Company Ltd is a company dealing with wholesale and retail business in Singida for the period of five years now. The company's financial year is January to December.

During the financial year 2016, it was discovered by the tax audit done by Tanzania Revenue Authority that the Company did not comply with the requirement of the law of filling tax return and tax payment. The following information was revealed:

(c) It submitted the provisional statement of estimated tax payable on 14/09/2016 and paid all the tax due on the same day.
(d) The taxable income calculated was supposed to be TZS.115,000,000.
(e) Other balance of tax was paid as required.
(f) The return on income (final accounts) was submitted on 30/09/2017.

(g) The Bank of Tanzania discounting rate at the time was 10%.

Required:
Calculate the penalties and interest to be paid, if any, as per tax laws in the country.

Question 4
The accounting period of the Great Co. Ltd ends on 31st December of each year. During the year of income 2017, the company fails to file/furnish the statement of estimated income on the due date. However, on 30/9/2017, the company files the estimated income of Tshs 100 million.
Unfortunately, the company also, delayed the submission of the final return of income which is submitted on 30/9/2018 showing an income tax amounting to Tshs. 40 million. The corporation tax rate is 30%.
Required:
Compute penalties if any payable under section 78 of the Tax Administration Act, 2015.

Answers to Self-Test Examination Questions

Answer to SEQ 1
(a) Penalties for late submission of Statement of Estimated Income Tax Payable and Return of Income (Section 78 of the Tax Administration Act, 2015)
(i) Penalty for the failure to file Statement of Estimated Tax Payable on or before the due date

- Due date: 30/11/20X5
- Filling date: 15/4/20X6.
- Months late: 5 Months
- Penalty for each month or part of a month
  The greater of
  (i) 2.5% (Tshs 42,000,000-0)= Tshs 1,050,000
  (ii) 15 Currency point = Tshs 225,000

Penalty = Tshs 1,050,000 X 5 Months= Tshs 5,250,000/=

(ii) Penalty for the failure to file Return of Income on or before the due date

- Due date: 28/2/20X7
- Filling date: 20/5/20X7.
- Duration of failure : 3 months
- Income tax payable = Tshs. 60,000,000
- Tax paid out at the start of month, May (installments = Tshs 42,000,000
- Penalty for each month or part of a month
  The greater of

(i) 2.5% (Tshs 60,000,000-42,000,000)= Tshs 450,000
(ii) 15 Currency point = Tshs 225,000

Penalty = 450,000 x 3 Months= Tshs 1,350,000

(b) Interest payable for the under estimation of estimated income tax payable (Section 75 of the Tax Administration Act, 2015)

If estimated Income tax payable is less than 80% of the actual tax shown in the return; there is underestimation.

Solution

- 80% of correct tax i.e. 80% xTshs 60,000,000 = Tshs. 48,000,000.
- Income tax paid by installment = Tshs. 42,000,000
- Excess = Tshs 60,000,000 – Tshs 42,000,000 = Tshs. 18,000,000
- Date of 1st instalment = 30/11/20X5
- Date of filing return of income 28/2/20X7,
- Duration = 15 months (periods)
- BOT statutory rate 15%

Interest:
PV = Tshs. 18,000,000
n = 15 months
i = 15%/12 months
$I = 18{,}000{,}000*(1+15\%/_{12})^{15}-1$
=Tshs 3,686,925

(c) Interest payable for the late payment of taxes (Section 76 of the Tax Administration Act, 2015)

(i) Payment for quarterly installment taxes (Section 88 Of the Income Tax Act Cap 332

Tax payable= (A – C)/B

B- Estimated income tax payable for the year income under section 4(1)a & b of the Income Tax Act Cap 332 2004 R.E 2014
(Tshs 140 million 30% =Tshs 42,000,000
C- Number of installments remaining including the current installment
D- Income tax paid prior the due date for the payment of installment tax by the way of withholding or installment

- **1st installment**

The due date for payment of the 1st installment is 30/11/20X6
Date paid 16/6/20X6.
Since it is paid after the due date, there is an interest under section 75
Amount of 1st installment = $(42{,}000{,}000-0)/_4$ = shs.10, 050,000
Duration of failure = 7 months
BOT interest rate 15%
Interest
$I = 10{,}050{,}000*(1+15\%/_{12})^{7}-1$
= 913,047

- **2^{nd} installment**

  The due date for payment of the 2^{nd} installment is 28/02/20X6
  Date paid 16/6/20X6.
  Since it is paid after the due date, there is an interest under section 75
  Amount of ^{2nd} installment = (Tshs 42,000,000-Tshs 10,500,000)/$_3$ = shs.10, 050,000
  Duration of failure= 4 months
  BOT interest rate 15%
  Interest
  $I = 10{,}050{,}000*(1+15\%/_{12})^4-1$
  $= 512{,}001$

- **3^{rd} installment**

  The due date for payment of the 3^{rd} installment is 30/05/20X6
  Date paid 16/6/20X6.
  Since it is paid after the due date, there is an interest under section 75
  Amount of ^{3rd} installment = (Tshs 42,000,000-Tshs 21,000,000)/$_2$ = shs.10, 050,000
  Duration of failure = 1 months
  BOT interest rate 15%
  Interest
  $I = 10{,}050{,}000*(1+15\%/_{12})^1-1$
  $= 125{,}625$

- **4^{th} installment**

  The due date for payment of the 4^{th} installment is 31/08/20X6
  Date paid 16/6/20X6.
  No failure

(ii) Interest for the late payment of Income tax to be paid on the date of filling Return of Income

Due date for payment: 28/2/20X7
Date the tax is paid: 20/5/20X7
Since it is paid after the due date, there is an interest under section 75
Duration of failure = 3 months
Amount payable on 28/2/20X7 = Tshs. 60,000,000 – 42,000,000 = Tshs. 18,000,000.
$I = 18{,}000{,}000*(1+15\%/_{12})^3-1 = 683{,}473$

Answer to SEQ 2

(i) The due date for filling provisional return was 31^{st} December 2013.
(ii) The due date for filling the final return was 31^{st} March 2015.
(iii) Amount of Income tax paid on 1^{st} instalment was as follows:

$$\textbf{First instalment} = \frac{\textbf{A – C}}{\textbf{B}}$$

A = income tax payable by the start of the period = TZS 240,000,000 x 30%
= TZS 72,000,000/=

C = income tax paid by the start of the period

B = No. of instalment = 4

1^{st} instalment = $\frac{72{,}000{,}000 - 0}{4}$

Amount paid by Muhidin & Co. Ltd. on 1^{st} instalment = TZS 18,000,000

4^{th} instalment = $\frac{\text{Revised estimate – Income tax paid}}{\text{No. of remaining instalment}}$

Income tax payable on revised estimate = 75,000,000
Income tax paid before the last instalment = 18,000,000 x 3
= TZS 54,000,000

Fourth instalment = $\frac{\text{TZS 75,000,000 – TZS 54,000,000}}{1}$
= TZS 21,000,000/=

(iv) Income tax paid on 30^{th} June 2015 by Muhidin & Co. Ltd.
Income tax payable = 300,000,000 x 30%
= 90,000,000
Income tax paid = 90,000,000 – 75,000,000
Therefore, the income tax paid on 30^{th} June 2015 was TZS 15,000,000/=

(v) Penalty paid by Muhidin & Co. Ltd. As according to s.78 of Tax Administration Act 2015:

Penalty for late lodging of provisional returns: 2 months late
Penalty = 72,000,000 x 2.5% x 2
= 3,600,000 vs 15,000 x 15 x 2
= 3,600,000 vs 450,000 (whichever is higher)
= TZS 3,600,000/=

Penalty for late filling of return of income: 3 months late
Tax payable = 300,000,000 x 30%
= TZS 90,000,000
Tax paid = TZS 75,000,000
Penalty = (90,000,000 – 75,000,000) x 2.5% x 3 vs 15,000 x 15 x 3
= 1,125,000 vs 675,000 (whichever is higher)

= TZS 1,125,000/=

Answer to SEQ 3

Calculated income was Tshs. 115,000,000/=
Tax will be 115,000,000 x 30% = 34,500,000
Per each Quarter payment will be = Tshs. 8,625,000/=

(a) **Penalties for late submission provision and final return of**

(i) **Provision return**

In the 1st Quarter the company was supposed to submit the statement of provision of tax payable on March 16 but was submitted on 14/09/2016, months late = 6 months
Penalty for late submission of return is;

- The higher of 2.5% of the tax assessed or 15 currency point whichever is higher, times months failure continues
- Tshs. 34,500,000 x 2.5% = 862,500

Or 15,000 x15 =225,000
The higher is 862,500

Penalty for failure to file provision	=	Tshs.862,500 x 6
	=	Tshs.5,175,000

(ii) Final return

Return on Income was supposed to be submitted on end of June 2017

- Was submitted on 30/09/2017
- Months late was 3 months
- Penalty for late submission of return is;
- The higher of 2.5% of the tax assessed or 15 currency point whichever is higher, times months failure continues
  - 0×2.5%=0
  - Penalty on late submission will be 15 currency point times the months late
    (15 15,000)3= 675,000/

(b) Interest payable for the late payment of taxes

(i) 1st installment tax

The company was supposed to pay 1st installment tax which was Tshs. 8,625,000 on the end of Month.

- But was paid on 14/09/2016
- Month late 6 months
- Interest on late payment
- $= 8{,}625{,}000 \times (1+ \frac{0.1}{12})^6 - 1) = 440{,}335$

(ii) 2nd installment of tax

For 2nd instalment the company was supposed to pay tax due ofTshs. 8,625,000 on end of June but paid on 14/09/2016

- Month late equal to two months
- Interest of failure to pay tax will be
- $8{,}625{,}000 \times (1+ \frac{0.1}{12})^3 - 1) = 217{,}427$

(iii) 3rd installment of tax

For 3rd installment the company was supposed to pay tax due, of Tsh. 8,625,000/= on 30/09/2016
Was paid on 14/09/2017 – no interest

Therefore

(i) Total Penalties are 5,175,000/ + 675,000/ = Ths 5,850,000/
(ii) Total Interest is 440,335 + 217,427 = Tsh 657,762
Hence the amount of penalty and interest to be payable to TRA will be TShs.6,507,762

Answer to SEQ 4

Year of income: 1/1/2017 to 31/12/2017
Due date for filing estimate: 31/3/2017
Date the estimate filed: 30/9/2017, (there is failure)

Due date for filing the return of income: 30/6/2018
Date the return filed: 30/9/2018 (there is failure as well)

Type of Failure and its penalty:
Failure to file statement of estimated income
Due date: 31/3/2017
End of failure: 30/9/2017
Duration: 6 months
Income tax payable on the income as per s. 4(1)(a) and (b)
= Tshs. 100 million x 30% =Tshs. 30 milion
Income tax paid at the start of the month = NIL

Penalty:
= (30 million-0) x 2.5% = 750,000 or 15 points currency (1 currency =Tshs 15,000) ,whichever is greater.
The greater (penalty) is Tshs. **750,000**

Tshs 750,000 is imposed for each month of failure i.e 6 months
The penalty amount is 750,000 x 6 = Tshs 4,500,000

Failure to file the return of income:
Due date: 30/6/2018
End of failure: 30/9/2018
Duration: 3 months
Income tax payable Tshs. 40million.
Tax paid out of it at te start of month,- NIL
Penalty:
Tshs. (40 million – 30 million) x 2.5% =Tshs. 250,000
Compare with 15 currency points (1 currency =Tshs 15,000), take the greater.
The greater (penalty) isTshs. **250,000**
Tshs 250,000 is imposed for each month of failure i.e 3 months

Penalty = Tshs. **250,000*3 =750,000**

VALUE ADDED TAX ACT

F1

STUDY GUIDE F1: INTRODUCTION TO VAT (THEORY AND PRACTICE)

Get Through Intro

Value Added Tax (VAT) is one of the most important sources of government revenue in Tanzania. So, proper understanding and implementation of the VAT laws is paramount. In this Study Guide, the meaning, nature, types and methods of computing of VAT are introduced.

Learning Outcomes

a) Explain the meaning, nature and operationalization of VAT
b) Illustrate types of VAT(Consumption, Gross-product, and Income type VAT)
c) Explain methods of VAT computation (addition, subtraction and credit method)
d) Explain the argument for and against VAT
e) Describe the Tanzanian VAT System

Explain the meaning, nature and operationalization of VAT and Illustrate types of VAT (Consumption, Gross-product, and Income type VAT).

[Learning outcome a, and b]

1. The Meaning, Nature And Operationalization Of VAT

VAT is an abbreviation for Value-Added Tax. It is an indirect tax on the consumption of goods and services in the economy. The nature of Value Added Tax (VAT) is such that it follows supply chains of taxable goods and services. This nature means each party in a supply chain of taxable goods or services pays VAT on his/her purchases; and when the person is a taxable person, collects VAT on his/her taxable sales. These taxable sales include sales and purchases of most goods and services. For instance, a supply chain of mobile phones might include wholesaler importers, other wholesalers who buy from the importers, retailers and finally, the final users. At the stage of importation, the importers pay VAT on imported mobile phones; the VAT is known as input tax as part of customs taxes. But, upon selling the mobile phones to other wholesaler's importers charges VAT on sales known as output taxes. The output taxes collected by the wholesaler importers are the input taxes paid by the other wholesalers. However, the other wholesalers charge VAT when selling the mobiles to the retailers, who also collect output taxes from the final users. By its nature every taxable person in the chain of supply is required personally to remit the value added taxes liability in a particular month to a revenue authority. The amount paid to the authority is the difference between output tax and input tax in that month. Alternatively, the amount can be computed by applying the VAT rate on the difference between the selling price before VAT and purchase price before VAT. Nevertheless, the total VAT paid by all taxable persons in the chain of supply is equal to the input taxes paid by the final users or the output taxes collected by the retailers. Consequently, VAT is a tax on consumption as it is borne by the final users of taxable goods and services.

2. Types of VAT (Consumption, Gross-product, and Income type VAT)

The selection of an appropriate type of VAT is crucial in the formulation of a viable VAT system. There are three possible VAT options: consumption, income, and gross domestic product types.

(i) Consumption VAT

Under consumption VAT all supplies of goods and services including purchases of capital goods are taxable and their input taxes are deductible in the period of acquisition .In this case, the firm in question is allowed to deduct the gross value of its product not only the non-capital inputs purchased from other firms but also the capital equipment so purchased i.e. the tax base is sales proceeds minus (capital goods purchased + materials purchased).

(ii) Production VAT (Gross Product VAT)

Production VAT recognizes only revenue transactions and totally disallows input taxes deduction on capital goods.

The tax base under gross product VAT for any firm is just sales minus materials (other than capital goods/fixed assets). This kind of VAT discourages investment because the VAT paid on purchase of fixed assets is not refunded.

(iii) Income VAT

In the income approach, all goods and services supplied are taxable but inputs paid on the purchases of capital goods is spread over the span of the products or assets as deprecation. Hence, the tax base is sales proceeds less material purchased + depreciation of capital equipment.

Explain the meaning, nature and operationalization of VAT and Illustrate types of VAT

[Learning outcome c, d, and e]

3. Methods of VAT computation

In the design of VAT, there are three options for VAT computation:

(i) **Addition method**

This method takes the total of rewards to factor of production and applies tax rates on that figure. The rewards might include wages, interest, rents, and profits

(ii) Subtraction method

Under this method the tax base is found by deducting purchases from sales. Under this method the tax base for a VAT is calculated as Gross receipts less purchases of goods (less capital goods if VAT is consumption VAT)

(iii) Credit method/The Invoice Method

The credit method requires the deduction of input tax from output tax in every VAT accounting period. This is the method Tanzania use for its VAT. Therefore, under the tax credit method, a taxpayer is allowed to deduct all deductible taxes paid (and payable) from all taxes collected (and collectible) in the respective reporting period.

4. Argument For And Against VAT

Value Added Tax is a type of tax which is valued in each stage of production, exchange and distribution.

The advantages of Value Added Tax (VAT) include:

(i) It is a broad –based tax. VAT covers many goods and services.
(ii) VAT promotes efficiency in production
(iii) VAT has a neutral distributive effects
(iv) VAT is simple in administration e.g only two tax rates (0% and 18%)
(v) VAT minimizes tax evasion, as selling prices are inclusive of VAT. Therefore, the customer has no option to evade VAT.

The disadvantages of value Added Tax (VAT) include:

(i) Generally, the VAT is regressive in nature. The rich and the poor have to pay the same rate of VAT on commodities. This may further increase income disparities among the rich and the poor.
(ii) VAT increases costs of goods and services for final consumers. This increase in price might results in inflation
(iii) There is need for appropriate record keeping and frequent cross-checking. This tends to impose burden to small firms. e.g monthly filling requirement, the apportionment of input tax.
(iv) It is or consumption tax, therefore it may affect the Level of consumption in a country.

5. The Tanzanian VAT System

Tanzania VAT system is a consumption type, taxing all taxable transactions whether involving capital or revenue expenditures. It follows the same nature of the VAT system described above. Consumption tax system encourages investment as input taxes incurred on purchase of capital goods are deductible in computation of value added tax liabilities.

Meanwhile, the consumption encourages saving and penalizes consumption, particularly consumption of taxable goods and services. On the other hand, Tanzania uses credit method of VAT computation. Under the tax credit method, a taxpayer is allowed to deduct all deductible taxes paid (and payable) from all taxes collected (and collectible) in the respective reporting period.

Another important part of Tanzania VAT system is tax rates. According to the system, taxable goods can be taxed either at standard rate i.e. 18% or zero rate i.e. 0.

Probably, the two VAT rates are easier to implement. Moreover, Tanzanian VAT system requires taxpayers to self-assess their tax liabilities each month and simultaneously file VAT returns and pay any owned VAT liabilities. Finally, the system also does not tax every transaction as only taxable supply of goods and services in Tanzania Mainland are taxable. Other goods are either exempted from VAT or outside the scope of VAT.

Self-Examination Questions

Question 1
List three types of VAT systems. Which system has been adopted in Tanzania and why?

Question 2
Briefly explain the methods of computing VAT which is being used by Tanzania VAT and explain the advantages of the said method.

Question 3
Give four reasons as to why the Value Added Tax (VAT) has become a prominent feature in tax systems of many LDCs.

Question 4
Discuss the reasons as to why the Value Added Tax (VAT) has become prominent feature in tax systems of many Less Developed Countries (LCD's).

Question 5

After more than twenty years' experience in Value Added Tax administration in Tanzania, there is a danger that many commercial enterprises now are familiar with the regular administrative requirements of VAT will believe the hype that VAT is a simple tax. It is not!

Required:

Comment on the truth or otherwise of this statement.

Question 6

The Value Added Tax (VAT) is a mainstay of fiscal systems in over 130 countries around the world. A variety of structures is used to tax the value of goods and services consumed by taxpayers in these countries.

Required:

(a) Discuss methods used in computation of the Value Added Tax and assess their practical applicability.

(b) Discuss reasons why the tax credit method is mostly preferred by many countries.

Answers to Self-Examination Questions

Answer to SEQ 1

(a) VAT systems are:-

(i) Consumption VAT

(ii) Production VAT (Gross Product VAT)

(iii) Income VAT

(b) Tanzania VAT system is a consumption type, taxing all taxable transactions whether involving capital or revenue expenditures.

Answer to SEQ 2

(a) There are three options for VAT computation:

(i) Addition method

This method takes the total of rewards to factor of production and applies tax rates on that figure. The rewards might include wages, interest, rents, and profits

(ii) Subtraction method

Under this method the tax base is found by deducting purchases from sales. Under this method the tax base for a VAT is calculated as Gross receipts less purchases of goods (less capital goods if VAT is consumption VAT)

(iii) Credit method/The Invoice Method

Under the tax credit method, a taxpayer is allowed to deduct all deductable taxes paid (and payable) from all taxes collected (and collectible) in the respective reporting period.

(b) Tanzania uses credit method of VAT computation.

Advantages of this method

- It works well with the consumption-type VAT.
- It attach tax liability to each transaction , providing good audit trial
- It allows application of multiple rates.

Answer to SEQ 3

VAT is common feature of most LDCs tax systems as it offers the following advantages.

(i) It is a broad –based tax. VAT covers many goods and services.

(ii) VAT promotes efficiency in production

(iii) VAT has a neutral distributive effects

(iv) VAT is simple in administration e.g only two tax rates (0% and 18%)

(v) VAT minimizes tax evasion, as selling prices are inclusive of VAT. Therefore, the customer has no option to evade VAT.

Answer to SEQ 4

Value Added Tax (VAT) has become prominent feature in the tax systems of many Less Developed Countries (LDC's), due to the following reasons: -

(i) Broad Tax Base

VAT ensures broader tax base and therefore high tax revenue at a relatively low tax rate compared to a single stage sales tax which would collect the same amount of tax revenue at a higher tax rate. This is made possible by the fact that VAT covers all VAT eligible taxpayers at all economic stages from manufacturing to the retail level and almost all goods and services. High tax revenue is also ensured by the fact that under VAT, taxpayers have incentive to keep proper records so as to facilitate future claims for refund, something which increase compliance.

(ii) Economic Neutrality

The VAT system is economically neutral i.e. it can raise the desired revenue for the Government without affecting economic decisions of producers and consumers. The choice of what economical resources to use in any economic activity or the decision on what item to buy or consume is determined by the productivity or utility or the product and no the tax effectiveness of that product. It does not matter therefore whether a product is produced by a labour intensive or capital intensive technology because the effective rate or tax is the same in whatever option. VAT does not tax investment and savings. VAT is payable on personal income only when the money spent on consumption rather than when it is earned as is the case with income tax. Under VAT system input tax paid on investment goods can be easily identified and fully credited.

(iii) Administrative Advantages

Budgetary effects VAT are efficient tax to administer, because it is simple and easy to understand since its value is based on the actual selling price; its rate is uniform; and exclusion of goods and services from the tax are limited to those essential for social or administrative reasons. It is easy to comply with and it does not affect much the free functioning of business and trade. This is because the tax is attuned closely to actual business transactions and accounting methods in application in the country, and is chargeable by the taxable businesses regardless whether the purchaser is a firm, a consumer, or a government entity.

(iv) Enforceability

VAT is easy to enforce by the use of invoice method of accounting for the tax i.e. self policing and the structure of VAT, which unlike other indirect consumption and turnover taxes such as sales tax, it does not provide for ample scope for evasion and corruption. Avoidance and evasion of tax, for example can easily be detected by cross checks of VAT invoices received by the purchasers against those retained by the sellers. VAT collection costs are low since the tax administered fully on a self-assessment basis and it normally exempts the typically hard to tax small businesses.

(v) Export Promotion

The VAT system encourages exports through prices identification and rebate of the VAT element in the export prices. It is almost impossible to determine the correct amount of tax element in the export prices because of the existing complicated rebate systems. One of the frequently voiced arguments of replacing other forms of indirect taxes with the tax credit type of VAT is that exports can easily be freed of tax under the later but not under the former. This may be done under VAT merely by zero rating all exports.

Answer to SEQ 5

(a) The statement that VAT is a simple tax is true in the following three main aspects:

(i) The registration requirement is simple i.e. any trader or businessman with a gross sales/turnover of TZS 100 million or above per annum is required to register.

(ii) One tax rate is applicable (standard rate of 18%) instead of numerous rates as in the repealed sales tax system/regime.

(iii) The determination of the tax payable or refund is simple. The input tax on purchases is deducted from the output tax on gross sales to determine the VAT payable.

(iv) There are no complicated capital deduction calculations, deductions etc.

On the other hand, the tax is complex (not simple) in the following aspects.

(i) Monthly filing requirements. In contrast to Income Taxation where filing is twice only in a year by way of provisional return and final return (excluding amendments), VAT filing is monthly.
(ii) Although only one standard rate is applicable exempted and zero rated supplies require distinction or consideration which is a source of complexity.
(iii) The apportionments of input VAT another source of complication.
(iv) The determination of the value of imports for VAT purposes is not so straightforward.

Therefore, it is true that VAT is simple in some aspects but it is quite complex in several other administrative considerations.

Answer to SEQ 6

(d) VAT is computed by adopting three alternative methods. These are:
1. The addition method.
2. The subtraction method
3. The tax credit/or invoice method

(i) In addition method, value added could be determined by summation of all elements of value added i.e. wages, profits, rent, and interest.
(ii) The subtraction method estimates value-added by taking the difference between the value of output and input.
(iii) Under the credit method, the tax on input is deducted from the tax on sales to arrive at the VAT payable by the dealer.

(e) (i) Makes crosschecking of tax paid at earlier stage more amenable as dealers are required to state the amount of tax in invoices.

(ii) Tax burden being dependent upon tax rate at the final stage dealers at intermediate stages do not have any incentive to seek treatment in tax rate.

(iii) Under invoice method, exports can easily be relieved of domestic indirect taxes through zero-rating exports.

SECTION F

VALUE ADDED TAX ACT

F2

STUDY GUIDE F2: IMPOSITION AND LIABILITY TO VAT

Get Through Intro

This Study Guide describes persons liable to pay VAT, types of supplies, place and time of supply. Also it explains the procedures for calculating net amount of VAT. Knowledge of computing VAT liabilities and supplies liable for VAT is important in ensuring smooth compliance of the tax law.

Learning Outcomes

a) Explain persons liable to pay Value Added Tax (Taxable persons)
b) Explain classification/ type of supplies (Taxable, zero-rated and exempt supplies)
c) Distinguish between composite and multiple supplies
d) Explain place of supply/Taxation for goods and services.
e) Describe when Value Added Tax becomes payable (Time of supply)
f) Explain the concept of consideration and value for supply
g) Describe the procedures for calculation and payment of net amount (VAT payable or refundable)

Explain persons liable to pay Value Added Tax (Taxable persons); explain classification/ type of supplies (Taxable, zero-rated and exempt supplies); and distinguish between composite and multiple supplies.

[Learning outcome a, b, and c]

1. Persons Liable To Pay Value Added Tax (Taxable Persons)

Imposition

Value added tax is imposed and payable on taxable supplies and taxable imports. (Section 3)

Person liable to pay VAT

Section 4 of the Act provides that, the following persons are liable to pay Value Added Tax-

(a) in the case of a taxable import, **the importer;**
(b) in the case of a taxable supply that is made in Mainland Tanzania, **the supplier;** and
(c) in the case of a taxable supply of imported services, **the purchaser.**

2. Type Of Supplies

Supplies are grouped into taxable, exempt, and supplies outside the scope of value added taxes. The proper application of value added tax system largely depends on classification of supplies because taxing exempt supplies may impose value added taxes when it should not. Also computations of input taxes deductible depends significantly on these classifications . Moreover, determination of when a trader is required either to apply for registration or deregistration depends on reaching a threshold of taxable supplies. The exemption and zero schedules may help in understanding these classifications.

Generally, a **'supply'** can be defined as something, goods or services available for another person either for consideration or otherwise.
The term ''supply'' has been defined under section 2 of the VAT Act, 2014 as any kind of supply whatsoever.

Types of supply
For VAT purposes, there are 3 types of supply. These are:
(i) Taxable supplies
- Standard rate - 18%
- Zero rate - First Schedule

(ii) Exempt supplies
(iii) Outside the scope

Taxable supplies
Section 2 of the VAT Act, 2014, define "taxable supply" as

b. a supply, other than an exempt supply, that is made in Mainland Tanzania by a taxable person in the course or furtherance of an economic activity carried out by that person; or
c. a supply of imported services to a taxable person who is the purchaser and acquires the services in the course of an economic activity if had the supply been made in Mainland Tanzania by a taxable person in the course of furtherance of an economic activity-
   (i) it would have been taxable at a rate other than zero; and
   (ii) the purchaser would not have been entitled to a credit for ninety percent or more of the value added tax that would have been imposed on the supply;

Taxable supply could be at:-

i. **Standard-rated Supply**
Technically, they include all supplies which are not zero rated supplies, exempted supplies, nor those outside the VAT system. The list of standard rated supplies is huge but not listed in the VAT Act 2014.

ii. **Zero-rated Supply**
Zero rated supplies are the second type of taxable supplies which differ from the standard rated supplies on tax rates; the standard rated supplies are taxable at 18% while the zero rated supplies are taxed at 0%. Consequently, zero rated supplies bear no value added taxes. The zero rated supplies are specified from section 54 to 63 of the Act as follows

1. A supply of immovable property, if the land to which the property relates is outside the United Republic.-section 54
2. A supply of goods exported outside URT including goods supplied to a tourist or visitor by a licensed duty-free vendor-section 55
3. A supply of goods by way of lease, hire, license, or similar supply, to the extent that the goods are used outside the United Republic. However, if the goods are a means of transport and the total period of the lease, hire, license, or similar supply is equal to or less than thirty days, are not zero rated –section 56
4. A supply of goods made in the course of repairing, maintaining, cleaning, renovating, modifying, treating, or otherwise physically affecting temporary imported goods.(i.e goods imported for re-export)-section 57
5. A supply of goods or services ,relates to the repair or replacement of goods under warranty, by warrantor, who is a non-resident and is not a registered person- section 58

6. Goods for use in international transport, (section 59) e.g
- Goods for use in repairing, maintaining, cleaning, renovating, modifying, treating, or otherwise physically affecting an aircraft or ship engaged in international transport.
- Goods for use in the aircraft or ship, fuel, and spare parts, and other articles or equipment, whether or not for immediate fitting.

7. A supply of services directly related to land outside the United Republic including a supply of services physically performed on goods situated outside the United Republic at the time the services are performed.-section 60
8. A supply of services made in the course of repairing, maintaining, cleaning, renovating, modifying, treating, or otherwise physically affecting temporary imported goods.(i.e goods imported for re-export)-section 61
9. A supply of services consisting of filing, prosecuting, granting, maintaining, transferring, assigning, licensing, or enforcing intellectual property rights for use outside the United Republic.-section 62
10. A supply of telecommunication services by a telecommunications service provider to a non-resident telecommunications service provider. –section 63

Exempt supplies

Section 2 of the VAT Act,2014 define an exempt supply as supply or import that is specified as exempt under the Act or a supply of a right or option to receive a supply that will be exempt;

The consequence of exemption is that:

- VAT is not charged on exempt supplies
- VAT incurred on purchases used in the making of exempt supplies cannot be reclaimed
- Accordingly if a business only has exempt supplies, it cannot register for VAT and cannot reclaim VAT incurred on inputs.
- If a business has both taxable supplies and exempt supplies, then special rules apply in respect of the input tax which may be deducted.

List of exempt supplies under the VAT, 2014 schedule

Supplies and imports exempt from value added tax

1. Agricultural implements

1	Tractors for agricultural use	8701.90.00
2	Agricultural, horticultural or forestry machinery for soil preparation or cultivation except lawn mower or sports ground rollers and parts.	84.32
3	Harvesting or threshing machinery except machines under Hs code 8433.11.00, 8433.19.00, 8433.90.00	84.33
4	Liquid sprayers for agriculture	8424.81.00
5	Powder sprayers for agriculture	8424.81.00
6	Spades	8201.10.00
7	Shovels	8201.10.00

8	Mattocks	8201.30.00
9	Picks	8201.30.00
10	Hoes,	8201.30.00
11	Forks	8201.90.00
12	Rakes	8201.30.00
13	Axes	8201.40.00
14	Tractor trailers	8716.10.10
15	New Pneumatic Tyres of a kind used in agriculture and forest vehicles	4011.61.00
16	Rotavator	
17	Poultry incubator	8436.21.00
18	Irrigation equipment	8424.81.00
19	Irrigation parts (sprinkler system, chemical injection system, water disinfection system, rain guns ,high pressure fogging equipments, irrigation computer ,filter for irrigation system	8424.90.00
20	Green house system	9406.00.10
21	Semen for bovine animal	0511.10.00
22	Semen for bovine animal	0511.99.10
23	Dam liner	3920

2. Agricultural inputs

No.	Item	HS code
1	Fertilizers	Chapter 31
2	Pesticides	3808.99.10 or 3808.99.90
3	Insecticides	3808.91.11 to 3808.91.99
4	Fungicides	3808.92.10 or 3808.99.90
5	Rodenticides	3808.92.10 or 3808.99.90
6	Herbicides	3808.93.10 to 3808.92.90
7	Ant sprouting products	3808.93.10 or 3808.93.90
8	Plant growth regulators	3808.93.10 or 3808.93.90

3. Livestock, basic agricultural products and foods for human consumption

1	Live cattle	0102.21.00
2	Live swine	0103.10.00
3	Live sheep	0104.10.10
4	Live goats	0104.20.10
5	Live poultry	0105.11.10

6	Unprocessed edible animal products	Chapter 2
7	Unprocessed edible eggs	0407.29.00
8	Unpasteurized or pasteurized cow milk except with additives and long life milk	4.01
9	Unpasteurized or pasteurized goat milk except with additives and long life milk	4.01
10	Unprocessed fish	3.02
11	Unprocessed edible vegitable	Chapter 7
12	Unprocessed fruits	8.1
13	Unprocessed nuts	8.02
14	Unprocessed bulbs	0601.10.00
15	Unprocessed tubers	0601.20.00
16	Unprocessed cereals	Chapter 10
17	Wheat or meslin flour	11.01
18	Maize flour	11.02
19	Unprocessed tobacco	2401
20	Unprocessed cashew nuts	0801.31.00
21	Unprocessed coffee	0901.11.00
22	Unprocessed tea	0902.10.00,
23	Soya beans	12.01
24	Ground nuts	12.02
25	Sunflower seeds	12.06
26	Oil seeds	12.07
27	Unprocessed pyrethrum	1211.90.20
28	Unprocessed cotton	1207.21.00
29	Unprocessed sisal	5303.10.00
30	Unprocessed sugarcane	1212.93.00
31	Seeds and plants thereof	12.09

4. Fisheries Implements

1	Floats for fishing nets	7020.00.10
2	Fishing nets	5608.11.00
3	Fishing vessels, factory ships and other vessels for processing or preserving fishery products	8902.00.00
4	Nylon fishing twine	
5	Outboard engine	8407.21.00

5. Bee-keeping implements

1	Bee hive	Any Description
2	Protective bee keeping jacket veil	6113.40.00
3	Mask	6307.9

4	Honey strainer	
5	Bee hive smoker	8424.89

6. **Diary equipment**

1	Hay making machine	8433.30.00
2	Cans and ends for beverages	7310.29.20
3	Milking machines	8434.10.00
4	Homogenizer, Butter churn, milk	8434.20.00
	pasteurizer	
5	Cream separator	8421.11.00
6	Milk plate heat exchanger	8419.50.00
7	Milk hose	3917.31.00,4009.12.00,4009.32.00
8	Milk pump	8413.60.00,8413.70.00,8413.81.00
9	Heat insulated cooling tanks	8419.89.00,7309.00.00,7310.00.00
10	Milk storage tanks	

7. **Medicine or pharmaceuticals products, including food supplements or vitamins supplied to the Government entities.**

8. **Articles designed for people with special needs**

1	Orthopaedic appliances, including crutches, surgical belts and trusses, splints and other fracture appliances, artificial parts of the body, hearing aids and other appliances which are worn or carried, or implanted in the body, to compensate for a defect or disability excluding other items under HSC9021.90.00	90.21
2	White cane for blinds or visually impaired	
3	Spectacle for correcting vision	9004.90.10
4	Contact lenses	9001.30.00
5	Spectacle lenses of glass	9001.40.00
6	Spectacle lenses of other materials	9001.50.00
7	Sunscreen and sun tan preparation used by albino	33.04
8	Braille	8469.00.007
9	Mechanically propelled tricycle for carriage of disabled persons	8713.1.00

9. Education materials

1	Dictionary and encyclopedia	4901.91.00
2	Printed books	4901.10.00
3	Newspapers	4902.90.00
4	Children pictures drawing or colouring	4903.00.00
5	Maps and hydrographic charts	4905.99.00
6	Examination question papers	4911.99.20
7	Instructional charts and diagrams	4911.90.10
8	Examination answer sheet	4911.99.90

10. Health care

1	A supply of medical, dental, nursing, convalescent, rehabilitation, midwifery, paramedical, optical, or other similar services where the services are provided: (a) by or in an institution approved for the provision of those services by the Government; and (b) by, or under the supervision and control of, a person who is registered as being qualified to perform that service under Tanzania laws, or whose qualifications to perform the services are recognised in Tanzania.
2	A supply of services in a nursing home or residential care facility for children, or for aged, indigent, infirm, or disabled persons who need permanent care, if the

11. Immovable property

1	A sale of vacant land.
2	A lease, license, hire or other form of supply, to the extent that it is a supply of the right to occupy and reside in residential premises.
3	A sale of immovable property, to the extent that the property relates to residential premises, not including: (a) the first sale of newly constructed residential premises; or (b) a subsequent sale if the premises have been occupied as a residence for less than two (2) years.

12. Educational services

1	A supply of services consisting of tuition or instruction for students provided by an institution approved by the Minister responsible for education, being: (a) a pre-primary, primary, or secondary school; (b) a technical college, community college, or university; (c) an educational institution established for the promotion of adult education, vocational training, improved literacy, or technical education; (d) an institution established for the education or training of physically or mentally handicapped persons; or **(e)** an institution established for the training of sportspersons.

13. Intermediary Services

1	Supply of financial services supplied free of charge.
2	Insurance premiums for aircraft.

3	Life insurance or health insurance.
4	Insurance for Workers Compensation.

14. Government entity or institution

A non commercial activity carried on by a Government entity or institution, except to the extent that the activity involves making supplies of goods, services or immovable property that are also supplied are to be supplied in Mainland Tanzania by at least the person who is a non government entity

15. Petroleum products

1	Aviation spirit	2710.12.30,
2	Spirit type jet fuel	2710.12.40
3	Kerosene type jet fuel (Jet A-1)	2710.19. 21
4	Petrol (MSP and MSR)	2710.12.20
5	Diesel (GO),	2710.19.31
6	Kerosene (IK)	2710.1922.
7	Bitumen	27.14 2713.20.00 and 2715.00.00
8	Liquefied petroleum and Natural gases	2711
9	Compressed Petroleum and Natural gases	2711
10	Compressed or liquefied gas cylinders for petroleum and Natural gases for cooking	7311.00.00

16. Supply of water, except bottled or canned water or similarly presented water.
17. The transportation of person by any means of conveyance other than taxi cabs, rental cars or boat charters.
18. Supplies of arms and ammunitions, parts and accessories thereof, to the armed forces.
19. Funeral services, for the purpose of this item funeral services includes:-coffin, shroud, transportation, mortuary and disposal services of human remains
20. Gaming supply.
21. Supply of solar panels, modules, solar charger controllers, solar inverter, solar lights, vacuum tube solar collectors and solar battery.
22. Supply of air charter services.

IMPORTS EXEMPT FROM VALUE ADDED TAX

Item No.	Description
1	An import of baggage or personal effects exempt from customs duty under the Fifth Schedule of the East African Customs Management Act, 2004.
2	An import of goods given, otherwise than for the purposes of sale, as an unconditional gift to the State.
3	An import of goods (including containers), if the goods have been exported and then returned to Mainland Tanzania by any person without being subjected to any process of manufacture or adaptation and without a permanent change of ownership, but not if at the time when the goods were exported, they were the subject of a supply that was zero-rated under this Act or under repealed Value Added Tax Act, Cap. 148.
4	An import of goods shipped or conveyed to United Republic for transshipment or conveyance to any other country.
5	An import of goods made available free of charge by a foreign government or an international institution with a view to assisting the economic development United Republic.
6	An import of food, clothing and shoes donated to non-profit organization for free distribution to orphanage or schools for children with special needs in Mainland Tanzania.
7	Import of goods by non-profit organization for the provision of emergency and disaster relief, and where such goods are capital goods, the goods shall be handled to the National Disaster Committee upon overtion, completion or diminishing of the disaster.
8	An import of goods by the religious organization for the provision of health, education, water, religious services in circumstances that, if services are supplied-without fee, charge or any other consideration in a form of fees; or on payment of any consideration, the fees or charges does not exceed fifty percent of the fair market value.
9	An import of goods that is exempt under an agreement entered into between the Government of the United Republic and another government or an international agency.

10	An import of goods by a registered and licensed explorer or prospector for the exclusive use in oil, gas or mineral exploration or prospection activities to the extent that those goods are eligible for relief from customs duties under the East African Customs Management Act, 2014.
11	An import of aircraft, aircraft engine or parts by a local operator of air transportation.
12	An import of railway locomotive, wagons, tramways and their parts
13	An import of fire fighting vehicles by the Government.
14	An import of laboratory equipment and reagents by education institution registered by the Ministry Responsible for education to be used solely for educational purpose.
15	An import of CNG plants equipment natural gas pipes, transportation and distribution pipes, CNG storage cascades, CNG special transportation vehicles, natural gas metering equipment, CNG refueling of filling, gas
16	Motor vehicle specifically designed for use by persons with disability
17	An import of machinery of HS Codes 8479.20.00, 8438.60.00, 8421.29.00, 8419.89.00 by a local manufacturer of vegetable oils for exclusive use in manufacturing vegetable oil in Mainland Tanzania.
18	An import of machinery of HS Code 8444.00.00, 8445.11.00, 8445.12.00, 8445.13.00, 8445.19.00, 8445.20.00, 8445.30.00, 8445.40.00, 8445.90.00, 8446.10.00, 8446.21.00, 8446.29.00, 8446.30.00, 84.47,8448.11.00, 8448.19.00, 8449.00.00, 8451.40.00 or 8451.50.00 by a local
19	An import of machinery of Chapter 84 by a local manufacturer of pharmaceutical for exclusive use in manufacturing pharmaceutical products in Mainland Tanzania.
20	An import of machinery of HS Code 8453.10.00 by a local manufacturer of hide and skins for exclusive use in manufacturing leather in Mainland Tanzania.
21	Import of ambulance of HS Code 8703.90.10 by a registered health facility other than a pharmacy, health laboratory or diagnostic centre.
22	An import of fire fighting vehicles by the Government.

Supplies outside the scope of VAT

A supply is out of VAT system if it results from an activity which is not an economic activity. For instance, salaries, other government taxes, appropriation of cash from businesses and other supplies made by non-VAT registered traders. There is no list of supplies which are outside the scope of VAT.

The following are examples of goods or services that are outside the scope of VAT. No VAT shall be charged or paid with respect of its supply:

i] Goods supplied by a trader not registered for VAT and is not required to do so.

ii] Goods or services bought or sold outside the United Republic of Tanzania

iii] Goods or services supplied in the course of something other than business

iv] Goods or services supplied for your own personal use - such as a hobby
v] donations to charity freely given by a business where the giver does not receive anything in return
vi] low cost welfare services provided by charities
vii] dividends
viii] wages

The list is not exhaustive.

3. Distinction Between Composite And Multiple Supplies

There is a little problem of categorizing a supply into either standard rated, zero rated or exempt supplies when it involves a supply of a single good or service. Yet, there is a challenge in deciding whether there is a single composite supply hence, single tax liabilities, or multiple supplies hence, multiple tax liabilities, when goods and services are supplied in bulk.

A composite supply

A composite supply occurs if a mixture of goods and/or services is supplied together in such a way that it is not possible to split the supply into its component parts. Thus, the supply as a whole must be considered in order to determine the rate of tax due (if any).

The composite supply applies where there is a principal element as well as an ancillary element and where ancillary element would not be supplied on its own without the principal element.

An **'ancillary service'** is defined as something that does not constitute for customers an aim in itself but is a means of better enjoying the principal service supplied.

Example

- Supply of mobile phone with an instruction manual
- Supply of lectures and learning materials
- Supply of Computer software coupled with training on how to operate

Multiple supply

Multiple supply is defined as being two or more supplies made in conjunction with each other to a customer for a total consideration covering all those where each of those supplies are physically and economically dissociable from each other.

- For example a car dealer may sell new or used cars with one year's free servicing.
- A computerised accountancy package is sold with one year's after sales support

In this arrangement each of this supplies made in conjunction with others is treated as an individual supply and taxable /exempt in its own right.

If none of the forms of supply is exempt and all are subject to VAT at the same rate, then it is not as critical to separate the elements of a supply.

Section 14 the VAT Act provides that where a supply consists of more than one element, the following criteria shall be taken into account when determining how this Act applies to the supply-

(a) every supply shall normally be regarded as distinct and independent;
(b) a supply that constitutes a single supply from an economic, commercial, or technical point of view, shall not be artificially split;
(c) the essential features of the transaction shall be ascertained in order to determine whether the customer is being supplied with several distinct principal supplies or with a single supply;
(a) there is a single supply, if one or more elements constitute the principal supply, in which case the other elements are ancillary or incidental supplies, which are treated as part of the principal supply; or
(b) a supply shall be regarded as ancillary or incidental to a principal supply if it does not constitute for customers an aim in itself but is merely a means of better enjoying the principal thing supplied.

Explain place of supply/Taxation for goods and services; describe when Value Added Tax becomes payable (Time of supply); explain the concept of consideration and value for supply and describe the procedures for calculation and payment of net amount (VAT payable or refundable)

[Learning outcome d, e, f and g]

4. Place Of Taxation For Goods And Services.

VAT is a destination based tax, i.e., the goods/services will be taxed at the place where they are consumed and not at the origin. So, the state where they are consumed will have the right to collect VAT. This, in turn, makes the concept of place of supply crucial under VAT as all the provisions of VAT revolve around it. Section 44 to 53 of the VAT Act,2014 provides the place of taxation rules as discussed below

a) **Supplies of goods**
A supply of goods shall be treated as a supply made in Mainland Tanzania if the goods are delivered or made available in Mainland Tanzania.

b) Inbound and outbound goods
- Goods installed or assembled in Mainland Tanzania by, or under a contract with the supplier shall be treated as a supply made in Mainland Tanzania.
- A supply of goods shall be treated as a supply made in Mainland Tanzania if the goods are dispatched or transported from Mainland Tanzania to a place outside the United Republic.

c) Supplies relating to immoveable property
- A supply of immovable property situated in Mainland Tanzania or a supply of services directly related to land situated in Mainland Tanzania shall be treated as a supply made in Mainland Tanzania.
- A supply of service directly related to immovable property shall be treated as a supply made in Mainland Tanzania if-
  (a) the land to which the property relates is not situated in Mainland Tanzania; and
  (b) the supplier is-
    i. a resident of Mainland Tanzania; or
    ii. a non-resident who carries on an economic activity at or through a fixed place in Mainland Tanzania.

d) Supply of services directly related to land
A supply of services directly related to land situated outside Mainland Tanzania shall be treated as a supply made in Mainland Tanzania if the supplier is a non-resident who is operating through a fixed place in Mainland Tanzania.

e) Supply of essential services
Where water, gas, oil, electricity, or thermal energy is supplied through a pipeline, cable, or other continuous distribution network and delivered to a place in Mainland Tanzania or from a place in Mainland Tanzania to a place outside the United Republic such supply shall be treated as a supply made in Mainland Tanzania.

f) Services supplied to a registered person
A supply of services by a non resident who is a registered person to a customer who is a registered person shall be treated as a supply made in Mainland Tanzania. However, this shall not apply if the customer is a non-resident who carries on an economic activity at or through a fixed place outside Mainland Tanzania and the supply is made
  (a) for the purpose of that economic activity; or
  (b) to that fixed place.

g) Telecommunication services

- A supply of telecommunication services shall be treated as a supply made in Mainland Tanzania, if a person in Mainland Tanzania, other than a telecommunications service provider, initiates the supply from a telecommunications service provider, whether or not the person initiates the supply on his own behalf. A person who initiates a supply of telecommunication services is the person who-
  - (a) controls the commencement of the supply;
  - (b) pays for the supply; or
  - (c) contracts for the supply.
- If it is impractical for the supplier to determine the location of a person due to the type of service or the class of customer, the person who initiates the supply of telecommunication service shall be the person to whom the invoice for the supply is sent.
- However, the requirement will not apply if the person who initiates the call in Mainland Tanzania is a non-resident who is global roaming while in Mainland Tanzania and who pays for the supply under a contract made with a non-resident telecommunications service provider, through a place outside the United Republic at which the non-resident is established.

Definition

"electronic services" means any of the following services provided or delivered through a telecommunications network-

i] websites, web-hosting, or remote maintenance of programmes and equipment;
ii] software and the updating thereof;
iii] images, text, and information;
iv] access to databases;
v] self-education packages;
vi] music, films, and games, including gaming activities; and
vii] political, cultural, artistic, sporting, scientific, and other broadcasts and events including broadcast television.

h) Services supplied to an unregistered person in Mainland Tanzania

A supply of any of the following services shall be treated as a supply made in Mainland Tanzania when supplied to a customer who is not a registered person-

(a) Services performed in Mainland Tanzania, if the services are received by a person in Mainland Tanzania who effectively use or enjoy the services in Mainland Tanzania;
(b) Services received for radio or television broadcasting at an address in Mainland Tanzania; and
(c) Electronic services delivered to a person who is in Mainland Tanzania at the time when the service is delivered.

i) Other services supplied to unregistered person within Mainland Tanzania

- Any other supply of services shall be treated as a supply made in Mainland Tanzania, if-
  - (a) the customer is a resident of Mainland Tanzania and is not a registered person; and
  - (b) the supplier is-
    - i. a resident of Mainland Tanzania; or
    - ii. a non-resident who carries on an economic activity at or through a fixed place in Mainland Tanzania; and
  - (c) the supply is made in the course of that economic activity or through that fixed place.
- A supply of services shall be treated as a supply made in Mainland Tanzania, if it is not treated as a supply made in-
  - (a) Mainland Tanzania in accordance with sections 51; and
  - (b) the supplier is-

1. a resident of Mainland Tanzania; or
2. a non-resident and carries on an economic activity at or through a fixed place in Mainland Tanzania.

j) Progressive or periodic supplies

Where a progressive or periodic supply is a series of separate supplies, the place where each supply takes place shall be determined separately.

5. The Time When Value Added Tax Becomes Payable (Time Of Supply)

The tax point is the time when a supply is deemed to have taken place for VAT purposes.
The tax point is important in respect of supplies for VAT purposes because:

- The tax point is used for determining the tax period in which VAT relating to the supply should be accounted for and;
- The tax point is used to decide which scheme or VAT rate will apply to a supply when there is a change in the VAT scheme of VAT rate.

Section 2 of the VAT Act, 2014 provides the rules for determining time of supply as follows

Time of supply

- in relation to a supply of goods, the time at which the goods are delivered or made available;
- in relation to a supply of services, the time at which the services are rendered, provided, or performed;
- in relation to a supply of immovable property, the earlier time at which the property is-
created, transferred, assigned, granted, or otherwise supplied to the customer; or delivered or made available

6. The Concept Of Consideration Of Supply

Generally the consideration of a supply is the tax base on which the VAT is charged. The amount of VAT is the consideration of supply multiplied by VAT rate.

The consideration of supply is the amount in money paid or payable by the person in response to, or for the inducement of the supply; and the fair market value of anything paid or payable in kind, whether directly or indirectly, by any person in respect of, in response to, or for the inducement of the supply. The consideration for a supply includes-

(a) any duty, levy, fee, charge, or tax including value added tax imposed under this Act that
a) is payable by the supplier on, or by reason of, the supply; and
b) is included in or added to the amount charged to the customer;

(b) any amount charged to the customer that is calculated or expressed by reference to costs incurred by the supplier;
(c) any service charge that is automatically added to the price of the supply; and
(d) any amount expressed to be a deposit paid when goods are sold in a returnable container and which may be refunded on the return of the container.

However, the consideration for a supply shall not include a price discount or rebate allowed and accounted for at the time of the supply.

Taxable of Value of imports

The value of an import of goods is the sum of -

(a) the value of goods for the purposes of customs duty under the East African Customs Management Act, whether or not duty is payable on the import;
(b) of the amount of any customs duty payable on the import; and
(c) to the extent not included under paragraph (a) or (b) in respect of-
    i. the cost of insurance and freight incurred in bringing the goods to Mainland Tanzania; and
    ii. the amounts of any tax, levy, fee, or fiscal charge other than customs duty and value added tax payable on the import of the goods.

Example

Joshua Co. Ltd imported goods worth Tshs20,000,000 from London, after paying freight of Tshs2,000, 000; insurance for Tshs1,000,000 and Tshs200,000 for clearance at a UK port. Determine the taxable value for VAT purpose given the import duty as 25%, excise duty of 20%, Railway and Development

Levy of 1.5% and VAT rate of 18%.The taxable value of imported goods is the value of the goods after including other expenses and taxes except VAT according to customs valuation model. Therefore the taxable value of imported goods is computed as follows:

Costs	20,000
Freight	2,000
Insurance	1,000
Clearance	200
Total before import duties	23,200
Import duties 25%	**5,800**
Valued before excise duty	29,000
Excise duty 20%	**5,800**
Railway and development Levy at 5% of CIF)	**348**
Taxable value	**34,800**

7. **Procedures For Calculating And Payment Of Net Amount (VAT Payable Or Refundable)**

   VAT on a taxable supply of goods or services shall be payable by a taxable person at the end of a prescribed accounting period or at any time which the Commissioner may prescribe. The prescribed accounting period currently prescribed by the Commissioner is each calendar month.

   The amount of VAT payable required to be submitted to the Commissioner by each taxable person shall be determined as follows:

Output VAT	XXX
Less: Deductible Input Tax	XXX
VAT Payable	**XXX**

The Output VAT is the VAT charged on taxable supplies (sales). There is no possibility for Output VAT to be related to exempt supplies.

The Deductible Input VAT involves VAT incurred on both purchases and importation of goods or services as well as on business expenses and capital goods. However, the business purchases and expenses whose associated Input VAT is allowable for deduction must be related to taxable supplies. Therefore, not all Input VAT incurred is allowable for deduction.

Self-Examination Questions

Question 1
Who is liable to pay Value Added Tax as provided under Section 4 of Tanzania Mainland VAT Act, 2014

Question 2
In the context of value added tax explain the following:
1. Taxable supplies
2. Exempt supplies
3. Standard rated supplies
4. Zero rated supplies

Question 3
Explain how making exempt supplies differs from making zero rated supplies for the purpose of VAT.

Question 4

a) Define the time of supply and explain the importance of the time of supply for the purpose of Value Added Tax.
b) Explain how time of supply is determined

Question 5

Why is it necessary for a VAT Act to provide clarification on the place of supply?

Answers to Self-Examination Questions

Answer to SEQ 1

The following persons shall be liable to pay value added tax-

- in the case of a taxable import, the importer;
- in the case of a taxable supply that is made in Mainland Tanzania, the supplier; and
- in the case of a taxable supply of imported services, the purchaser

Answer to SEQ 2

Taxable supplies

These are supplies on which Value Added Tax (VAT) is charged, and they consist of standard-rated supplies and Zero-rated supplies.
Standard-rated supplies are those on which VAT is charged at the rate of 18% on the VAT exclusive amount and the VAT fraction of 18/118 is used if the amount is inclusive of VAT.
Zero-rated supplies are those on which VAT is charged at the rate of 0%.

Exempt supplies

These are supplies of goods and services on which no VAT is charged, and no input VAT attributed to them is available for credit. These supplies are not taken into account in determining whether or not a trader is a taxable person.

Answer to SEQ 3

The main difference between making exempt supplies and zero rated supplies are as follows:

1. A trader who only makes exempt supplies cannot register for VAT while a trader who makes only zero rated supplies can register for Value Added Tax.
2. When determining whether a trader should register for VAT by reference to the level of turnover, the turnover of exempt supplies is not taken into account while that of zero rated supplies is taken into account.
3. All the input vat that is attributed to exempt supplies cannot be recovered while all the input vat that is attributable to zero rated supplies is recoverable.

Answer to SEQ 4

(a) The time of supply is a tax point when a supply is said to made. For VAT purposes the time of supply is important because:
    (i) It is used for the purpose of determining the tax period in which VAT on a supply is to be accounted for,
    (ii) In the case of a change in the VAT rate or scheme the tax point will be used to determine which VAT rate or scheme applies to a particular supply.

(b) Time of supply
    (i) in relation to a supply of goods, the time at which the goods are delivered or made available;
    (ii) in relation to a supply of services, the time at which the services are rendered, provided, or performed;
    (iii) in relation to a supply of immovable property, the earlier time at which the property is-created, transferred, assigned, granted, or otherwise supplied to the customer; or delivered or made available

Answer to SEQ 5

The place of supply is the place where a supply is made and where VAT may be charged and paid. When goods or services are supplied, then for VAT purposes, it is essential to know the 'place of supply'. This determines whether the supply is subject to VAT charging rules in Mainland Tanzania or it is outside the scope of VAT in Mainland Tanzania. Therefore, goods or services are VAT chargeable in Mainland Tanzania if the place of supply is Mainland Tanzania.

SECTION F

VALUE ADDED TAX ACT

F3

STUDY GUIDE F3: VAT REGISTRATION AND REGISRATATION

Get Through Intro

The tax authority needs to know who is going to pay the tax and whom it can pursue in the event of non-payment. Basing on that, the authority is assured of tax payments by obliging traders to *register* for the tax. This guide discusses registration and deregistration procedures.

Learning Outcomes

a) Explain the purposes and types of VAT Registration
b) Describe registrations for branches and divisions
c) Explain the statutory records to be maintained by VAT registered traders.
d) Explain the causes and effects of cancellation of registration

Explain the purposes and types of VAT Registration; and describe registrations for branches and divisions.

[Learning outcome a and b]

1. The Purposes And Types Of VAT Registration

VAT is charged and thus payable by every person registered under the provisions of the VAT Act, 2014 to become a VAT registered trader. Other traders or any other persons who are not registered for VAT are not allowed to charge VAT whatsoever.

1.1 Purposes of Registration for VAT

The purposes of registration are to:

(a) Record the particulars of taxable persons for the purpose of control and collection of tax.
(b) Enable them to take credit of input tax on their purchases of taxable supplies; and
(c) Allow them charge output tax on their taxable supplies and to issue tax invoices.

1.2 Types of VAT Registration

There are 3 main types of registrations: Normal registration, Compulsory registration and intending traders' registration.

(i) Normal registration

If a person's taxable sales exceed the registration threshold or have the reason to believe that it will exceed, then the person need to register. The registration limit is currently a cumulative total taxable turnover of Tshs 100,000,000 for the last twelve consecutive months. Whether the threshold is exceeded or not may be tested as follows:

Historic Turnover Test

The trader is required to look at the cumulative total of taxable sales for the last 12 months if it exceeds Tshs 100,000,000 (or for the last 6 months if it exceeds 50mil) or since the commencement of business whichever is shorter.

If the total exceeds the registration limit, currently Tshs 100 mil, then the trader must apply for registration by notifying the Commissioner in writing within 30 days since the end of the month in which the turnover exceeded the limit.

Future Prospects Test

This test is considered at any time, when taxable supplies in the next 30 days are expected to exceed a per annum cumulative total taxable turnover of Tshs 100mil or a consecutive 6 months cumulative total taxable turnover of Tshs 50mil.

Turnover for VAT purposes

Section 28(5) provides that for the purpose of VAT registration, a person's turnover shall be the sum of-

(a) total value of supplies made, or to be made, by the person in the course of an economic activity carried out during that period; and

(b) total value of supplies of imported services made, or to be made, to the person during the period that would be taxable supplies if the person was a taxable person during that period.

Regulation 10(2) of the VAT (General) Regulations, 2015 provides that, a person's turnover in respect of supplies of imported services shall be considered for registration where that person has a turnover resulting from taxable supplies other than supplies of imported services.

Amounts excluded from the Turnover

Section 28(6) states that the following amounts shall be excluded when calculating the person's turnover -

(a) the value of a supply that would not be a taxable supply if the person were a taxable person;
(b) the value of a sale of a capital asset of the person;
(c) the value of a supply made solely as a consequence of selling an economic activity or part of that economic activity as a going concern; and
(d) the value of supplies made solely as a consequence of permanently ceasing to carry on an economic activity.

Regulation 10(1) of the VAT (General) Regulations, 2015, provides that:-

Any application for registration under sections 28 shall be made in the form VAT 101 prescribed in the schedule to these regulations and lodged with the Commissioner within thirty days from the date of such requirement (section 30).

(ii) Compulsory registration

When a person fails to apply for the VAT registration within 30 days, the Commissioner General, compulsory register the person and not later than 14 days after the day on which the registration is done, notify the person on the registration. Also where there is a good reason including protection of government revenue, the commissioner general may register the person for VAT regardless of the turnover

The following are other persons required to register regardless of turnover:

- The person carries on an economic activity involving the supply of professional services in Mainland Tanzania, whether those professional services are provided by the person, a member or employee of that person-section 29(1)(a)
- A Government entity or institution which carries on economic activity (section 29(2)

(iii) Intending traders registration

VAT Act, 2014 allows any person who has grounds for believing he will qualify for registration to apply for registration. Traders who intend to start trading fall into this category and may seek registration in order to recover any input tax incurred in setting up the business (e.g. equipment, office machinery, lawyers, and architects fees).

Section 28(3) provides that the Commissioner General may register a taxable person as intending trader upon fulfilling the following conditions-

(a) provide sufficient evidence to satisfy the Commissioner of his intention to commence an economic activity, including contracts, tenders, building plans, business plans, bank financing;
(b) the person makes or will make supplies that will be taxable supplies if the person is registered;
(c) Specify the period within which the intended economic activity commences production of taxable supplies.

Regulation 13(2) further provides that, the Commissioner General shall register applicant as an intending trader upon satisfaction that the documentary evidence indicates that the applicant will make taxable supplies and the registration threshold will be attained within a period of twelve months from the date of commencement of producing taxable supplies.

2. Registrations Of Branches And Divisions

Many businesses operate from more than one set of premises (branches) or may structure their organization and create autonomous units within same legal entity and describe them as divisions. However, the registration by a kind of business shall be a single registration, which shall cover all economic activities undertaken by that person's branches or divisions.

This means that, all branches/divisions activities are part of one legal entity and all figures (turnover, VAT etc.) are amalgamated for completion of a single VAT return.

3. Rights And Obligations Of Vat Registered Persons

Once registered, the taxable person will be issued with a registration certificate and the VAT Registration Number (VRN). The taxable person will be required to display the certificate at a conspicuous place in the business premises. Moreover, he will be required to quote the VRN number on each tax invoice issued. Then the person will be entitled to the following requirements:

i] Charge output tax on each taxable supply
ii] File returns
iii] Recover input tax (subject to some restrictions)on business purchases and expenses
iv] Maintain appropriate VAT records
v] Use Taxpayer Identification Number and a Value Added Tax Registration Number on all documents required to be issued.

On top of the above requirements, the registered person is required to notify the Commissioner in writing in respect of “changes in business circumstances”.

A Person’s particulars/circumstances often change after registration. Quite often these changes can affect the ‘legal entity’ of the business and action needs to be taken by the trader and by the VAT Department. Section 37 of the VAT Act and Regulations 16 deals with this situation, under section 37 ,a registered person shall, notify the Commissioner General in writing; within fourteen days of the occurrence of the following changes-

(a) the name of the registered person, business name, or trading name of the person;
(b) the address or other contact details of that person;
(c) one or more places through which the person carries on an economic activity in Mainland Tanzania;
(d) the nature of one or more of the economic activities carried on by the person;
(e) the person’s status as a registered person; and
(f) any other changes as prescribed in the regulations.

Explain the statutory records to be maintained by VAT registered traders; and explain the causes and effects of cancellation of registration.

[Learning outcome c and d]

4. Statutory Records To Be Maintained By VAT Registered Traders

Complete records are essential in insuring that correct VAT has been paid and claimed by taxable persons. Incomplete records means VAT is computed from inaccurate information.
The following are statutory records to be maintained by VAT registered traders**.**

(i) **Tax invoice**

The VAT registered trader must issue a serially numbered true and correct tax invoice generated by electronic fiscal device in respect of supplies made .Tax invoice shall include the following information-

i] the date on which it is issued;
ii] the name, Taxpayer Identification Number and Value Added Tax Registration Number of the supplier;
iii] the description, quantity, and other relevant specifications of the things supplied;
iv] the total consideration payable for the supply and the amount of value added tax included in that consideration;
v] if the value of the supply exceeds the minimum amount prescribed in the regulations, the name, address, Taxpayer Identification Number and value added tax registration number of the customer; and

(ii) **Adjustment notes**

Taxable persons should issue the adjustment notes when there is increasing or decreasing adjustment event of the previously accounted VAT. An adjustment note which is required to be issued shall include the following information-

- the date on which it is issued;
- the name, Taxpayer's Identification Number and Value Added Tax Registration Number of the supplier;
- the nature of the adjustment event and the supply to which it relates;
- the effect on the amount of value added tax payable on the supply;
- if the effect on the value added tax payable on the supply exceeds, the minimum amount prescribed in the regulations, the name, Taxpayer's Identification Number and Value Added Tax Registration Number of the customer; and

(iii) **Documentation issued by or to agents**

Where a taxable supply is made by an agent or to an agent on behalf of a principal and both the agent and principal are registered persons, any documentation required to be issued by the principal, including tax documentation, may be issued by the agent or to an agent in the name, address, Taxpayers Identification Number and value added tax registration number of the principal.

Where a taxable supply is made to an agent acting on behalf of a principal and both the agent and the principal are registered, any documentation required to be issued to the principal, including a tax invoice generated by electronic fiscal device or adjustment note, may be issued to the agent and shall be in the name, address, Taxpayer Identification Number and value added tax registration number of the principal.

(iv) **Records and accounts**

A taxable person shall keep record of all accounts, documents, returns, and other records that are required to be issued or given under this Act, or such other tax law, including

- tax invoices and adjustment notes issued and received by the person;
- customs documentation relating to imports and exports of goods by the person;
- records relating to supplies of imported services to the person, whether or not those supplies were taxable supplies;
- a value added tax account that records, for each tax period, all the output tax payable by the person in that period, or the input tax credit the person is allowed in that period, and all the increasing and decreasing adjustments that the person is required or entitled to make in that period; and
- records showing the deposit of amounts paid to the Commissioner General under this Act.

The records referred to shall be maintained-

- for at least five years from the end of the tax period to which they relate; or
- until a later date on which the final decision is made in any audit, recovery proceedings, dispute, prosecution, or other proceedings under this Act relating to that tax period.

5. Causes And Effects Of Cancellation Of Registration

Deregistration is the process of removing or cancelling a registered person from the VAT register

5.1 Circumstances for deregistration

(i) Taxable person ceases to make taxable supplies.

If a taxable person ceases to make taxable supplies such person will then be cancelled from VAT registration.

(ii) Taxable turnover falls below the registration threshold.

A registered person ceased to be liable for registration when the Commissioner is satisfied that the level of taxable supplies has fallen below the registration threshold.

(iii) **Cessation of economic activity /business**

If a registered person ceases to carry on an economic activity and will no longer carry on a business, the registration may be cancelled. Section 41(1) (b) gives powers to the Commissioner General to cancel the registration of a person who is not carrying on an economic activity;

(iv) **Provision of false or misleading information**
Section 41(1) (a) provides that, the commissioner may cancel the registration of the person obtained registration by providing false or misleading information;

5.2 Liabilities or obligations after cancellation of registration
A person who ceases to be registered remains liable for any liabilities or obligations incurred while he was registered and required not to issue Tax Invoices(s) or show VAT on all of his/her receipts for the whole period he/she remain de- registered.

Self-Examination Questions

Question 1
Explain the types of registration for the purposes of Value Added Tax (VAT).

Question 2

Explain what is meant by pre-registration input VAT and describe the circumstances under which a business may recover pre-registration input VAT.

Question 3
List any Six (6) contents which must appear on the tax invoice.

Question 4
Nchimunya started running a retail business making standard rated taxable supplies on 1 June 2017. She made sales of Tshs 6,000,000 in the month of June. Her sales increased by Tshs 21,000,000 each month from July 2017 to November 2017. From December 2017, she expects sales to be Tshs 17,000,000 per month. Her standard rated expenses were Tshs 35,000,000 per month and are expected to remain at this level in future. Nchimunya is not sure whether she is required to register her business for Value Added Tax.
Required
(i) Explain the Value Added Tax registration requirements to Nchimunya.
(ii) State, giving reasons, when Nchimunya will be required to register for VAT.
(iii) Explain three (3) obligations Nchimunya will have once she registers her business for VAT.
Question 5
Describe **three (3)** circumstances which may result in a business being de-registered for VAT

Question 6
Briefly discuss different types of Value Added Tax (VAT) registrations and minimum criteria/threshold for each type as given in the Value Added Tax Act, 2014.

Question 7
(a) Explain how the accrual basis of VAT tax accounting may adversely affect a taxpayer's cash flow position. Suggest one way for ameliorating the cash flow problem.
(b) It has sometimes been suggested that the current TZS 100 million turnover thresholds for VAT registration and the 18% VAT single rate should be reduced to TZS 50 million and 15% respectively. What is the basis or justification for the above suggestion?
(c) The VAT single rate policy or structure has been in operation for more than five years. It is now probably appropriate to review this policy in favour of a VAT multiple rates policy or structure. The change would allow the provision of preferential rates for essential business inputs such as the utilities (water, electricity and telephone) for the mega consumers of such utilities (mining and industry) to increase their production and tax revenue. Comment.

Answers to Self-Examination Questions

Answer to SEQ 1
(i) Normal registration
A trader is required by law to register for VAT if the turnover of his/her taxable supplies, excluding VAT, for the twelve months or six months exceeds registration threshold.

The current registration threshold is Tshs 100,000,000 per twelve months or Tshs 50,000,000 per six months. Registration should be made within 30 days from the date when the registration threshold is exceeded.

(ii) Compulsory registration

When a person fails to apply for the VAT registration within 30 days, the Commissioner General, compulsory register the person and not later than 14 days after

Intending traders registration

Intending traders are suppliers who are registered for VAT before they commence trading activities. Such registration is normally for the sole purpose of claiming input tax.

Answer to SEQ 2

This is the VAT that is incurred on supplies acquired prior to the time of obtaining registration for VAT

Conditions for recovery of pre-registration of input VAT

For pre-registration tax to be recoverable:

- The goods should have been acquired within a period of up to six months prior to the effective date of registration may be allowed,
- The goods are in stock on the effective date of registration.

In other words, input tax incurred prior to registration cannot be recovered with regard to goods that have already been supplied out or consumed regardless of the six-month period.

Answer to SEQ 3

Details on the tax invoice:

i] the date on which it is issued;

ii] the name, Taxpayer Identification Number and Value Added Tax Registration Number of the supplier;

iii] the description, quantity, and other relevant specifications of the things supplied;

iv] the total consideration payable for the supply and the amount of value added tax included in that consideration;

v] if the value of the supply exceeds the minimum amount prescribed in the regulations, the name, address, Taxpayer Identification Number and value added tax registration number of the customer

Answer to SEQ 4

(i) VAT registration is required when a business makes taxable supplies in the following circumstances: VAT registration is required once the VAT exclusive taxable supplies of a business exceed Tshs 100,000,000 for any period of twelve months, or Tshs 50,000,000 for any period of six months. Once this happens, a business has an obligation to inform TRA within 30 days of the end of the month in which the registration limit is exceeded. Registration will become effective on the first day of the following month. A business which expects the turnover of taxable supplies, excluding VAT, for the following twelve months to exceed Tshs 100,000,000 or for the following six months to exceed Tshs 50,000,000 must register for VAT immediately under this same rule. In such cases, notification is required by the end of that 30 day period with registration being effective from the start of that period.

(ii) The sales will exceed the annual VAT registration limit of Tshs 100,000,000 in September 2017, when the cumulative sales from June 2017 will be Tshs 150,000,000. She will therefore have to inform TRA by the end of October 2017 and her VAT registration will be effective as of 1 November 2017, or from an earlier agreed date. Alternatively, the half year registration threshold of Tshs 50,000,000 will be exceeded in August 2017, when cumulative sales will be 81,000,000. In this case the TRA will have to be informed by the end of September 2017.

(iii) Nchimunya will have the following obligations in relation to VAT once registered:

- She will be required to issue fiscalised tax invoices/EFD receipts in respect of the supplies she makes.
- She will be required to complete and submit VAT returns, and pay VAT on the due dates.

- Nchimunya must maintain VAT records for a minimum period of at least five years and allow VAT inspectors access to the VAT records at any time.
- Nchimunya will have informed the Tanzania Revenue Authority of any change in the legal circumstances of her business that will warrant a cancellation of the VAT registration.

Answer to SEQ 5

Circumstances for deregistration

(i) If the taxable person ceases to make taxable supplies. .

(ii) If the taxable turnover falls below the registration threshold.

(iii) If the taxable person ceases to carry on an economic activity and will no longer carry on a business

Answer to SEQ 6

(i) **Normal registration**

Occurs when a taxpayer register for VAT when his taxable turnover exceeds registration threshold of TZS.100,000,000 for consecutive 12 months✓ or TZS.50,000,000 for consecutive 6 months.✓ Or when a person required to be registered for VAT apply for registrations as service professional providers and government entity.

(ii) **Compulsory registration**

This occurs when a person fails to apply for VAT within 30 days,✓ the Commissioner General compulsory register the person and later than 14 days after the day of registration, notify the person✓ on registration. Or this can be done if there is good reason of doing so including protection of government revenue. The person may be registered regardless of the person's turnover.

(iii) **Intended traders**

This can be referred to the person in process of setting economic activity with intention of making taxable supplies with a turnover of excess of the VAT registration threshold✓ but have not yet started making the taxable supplies.

Answer to SEQ 7

(a) VAT is computed and accounted for on accrual basis of accounting of sales and purchases whether the sales or purchases are made in cash or on credit. Where the sales or purchases are made on credit and the credit period is prolonged, the seller is still required to pay the tax on the due date although he has not collected adequate cash from his customers. Since there may not be adequate cash for payment of the tax, the seller is forced to pay the tax out of his private resources or borrow money at considerable interest in order to avoid penalties for failure to pay the tax on the due date. Even where a VAT refund is due to the taxpayer it takes at least six months to secure the refund from the TRA. TRA should allow payment of VAT in instalments or pay on cash basis.

(b) The reduction of the VAT registration threshold and the rate of VAT will have the following advantages:

Reduction of registration threshold.

- The current TZS 100 million threshold is too high resulting into:
- Many businessmen below the TZS 100m turnover are excluded;
- Some big businessmen try to fit themselves below the TZS 100m threshold.
- The reduction of the threshold will increase the tax base, i.e. increase the number of registered taxpayers as more people will qualify for registration

- An increase in registration will in turn increase revenue collection although administration costs may also increase.

Reduction of VAT rate:

- The current 18% rate is too high, which may cause tax evasion as people try to avoid the heavy tax burden.
- A lower rate will encourage a higher level of voluntary tax compliance.
- As compliance improves it will boost revenue collection.
- The reduced rate will make Tanzania more competitive to investors within the East African Community region.

(c) **Advantages** of a multiple VAT rate structure and lower rate for the utilities.

- It is likely to increase revenue yield as consumption of the utilities increases with more production.
- Lower VAT rate on utilities will also reduce the cost of industrial inputs resulting into cheaper goods.
- Affordable goods for the public raises the standard of living for the people.

Disadvantages:

- A multiple VAT rate structure reverts to the old sales tax system which was full of administrative complexity and cumbersome administration.
- Complexity of the law leads to tax evasion (less revenue) as taxpayers try to reclassify goods to take advantage of the lower rates categories.

SECTION F

VALUE ADDED TAX ACT

F4

STUDY GUIDE F4: INPUT TAX CREDITS

Get Through Intro

After knowing types of supplies, one needs to know how input taxes are computed and when input taxes can be deducted as explained in the characteristics of VAT. This Study Guide deals with conditions necessary for deduction of input taxes

Learning Outcomes

Learners will be able to:

a) Explain conditions for the person to claim /deduct input tax

b) Describe non -deductible input taxes

c) Explain conditions for claiming pre- registration input tax

d) Explain conditions for deduction of input tax on bad debts

e) Describe deduction and payments of input tax on imported goods and services

Explain conditions for the person to claim /deduct input tax and describe non - deductible input taxes.

[Learning outcome a and b]

1. Conditions For The Person To Claim /Deduct Input Tax

A taxable person is entitled to claim as a deduction any VAT, he has incurred on acquisition of goods or services for the purpose of his business provided that the goods or services are acquired wholly or partly for the purpose of making taxable supplies, including zero rated supplies. The “input tax” is claimed by deducting it from the “output tax” in the VAT return.

The general rules for input tax deduction is that:

(a) All input tax directly attributable to taxable supplies is allowed (except on non creditable purchases)

(b) Input tax directly attributable to exempt supplies is not allowed

(c) Where the input tax that is not directly attributable to either taxable or exempt supplies, an apportionment must be done for each tax period, to determine the allowable amount of that input tax.

Conditions for the taxable person to claim/deduct input tax

Apart from the above rules the following are general conditions for input tax deduction:-

i) The amount to be claimed must actually be VAT properly charged by the another taxable person or relate to a taxable importation

ii) The supplies on which the tax was charged must be made to the taxable person seeking to claim the input tax

iii) The supplies must have been incurred for the purpose of the business. Goods or services must be used or to be used for the purpose of the business

iv) The person seeking to claim input tax must hold satisfactory documentary evidence of the supplies in support of his/her claim.

v) The input tax must be incurred not more than six months from the date of tax invoice, fiscal receipt or other evidence

vi) The supplies received must not be subject to input tax restrictions i.e motorcars, entertainment, and subscription.

2. Non -Deductible Input Taxes

Generally a taxable person will be able to deduct or claim input tax credit against the output tax chargeable on his taxable supplies except on the following purchases/expenses. (Section 68(3)-

a) An acquisition of goods, services, or immovable property, to the extent that it is used to provide entertainment, unless the person’s economic activity involves providing entertainment in the ordinary course of the person’s economic activity;

b) An acquisition of a membership or right of entry for any person in a club, association, or society of a sporting, social, or recreational nature;

c) An acquisition or import of a passenger vehicle, or of spare parts or repair and maintenance services for a passenger vehicle, unless the person’s economic activity involves dealing in, hiring out, or providing transport services in passenger vehicles and the vehicle was acquired for that purpose. The restrictions are discussed in more details below

Explain conditions for claiming pre- registration input tax; explain conditions for deduction of input tax on bad debts and describe deduction and payments of input tax on imported goods and services.

[Learning outcome c, d, and e]

3. Conditions For Claiming Pre- Registration Input Tax

Section 79, generally provides that, a person who is not formally registered for the tax is not entitled to tax credit in respect of VAT paid on goods or services purchased. However when such person becomes registered, tax credit may be claimed for any input tax paid on taxable goods held in stock at the date of registration, provided the taxable person has the necessary tax invoice and documentary evidence to support the claim. Input tax credit is allowed only for stock purchased or imported within the period of six months prior to the date of registration. The taxable person is allowed to make an appropriate deduction from the output tax payable in any one of the first three tax periods after the person becomes a registered person.

4. Conditions For Deduction Of Input Tax On Bad Debts

A VAT Registrant may also claim an input tax deduction for VAT on any bad debt that was written off, since output tax for such debt would have been reported for in the tax period when the credit agreement commenced. If at any time a taxpayer recovers any of this debt, the VAT recovered must be reported as output tax once again, in that period. Regulation 25 of VAT (General) Regulations, 2015 provides that;-

(i) A taxable person may deduct input tax in respect of debt which has become irrecoverable.

(ii) A taxable person may deduct input tax if –

- (a) consideration for a taxable supply was payable in monetary terms;
- (b) the taxable person accounted for the supply in a value added tax return; and
- (c) the amount of input tax to be claimed is calculated by applying a tax fraction to the actual amount written off.

(iii) A debt shall be considered irrecoverable, if-

- (a) the taxable person has undertaken action for recovery of the debt or has handed over the bad debt to an attorney or debt collector for recovery.
- (b) The action for recovery has exhaustively proven futile; and
- (c) the taxable person has made all necessary entries in the books of account, including writing-off the bad debt;

(iv) Where a taxable person subsequently receives payment in respect of a bad debt written off, the person shall account for output tax in the tax period in which the payment is received.

Note

Under section 74 (2) (a),of the principal Act, the debt is deemed overdue and hence subject to the write off if it became overdue by more than 18 months

5. Deduction Of Input Tax On Imported Goods And Services

The destination principle requires a charge to VAT to be placed on all imports. This is usually done through a charging provision that parallels the one on internal supplies. The parallel provision normally adopts and adapts the laws imposing customs duties on the imported goods. The laws determining whether items are goods (inclusion in the tariff), whether they are imported (rules of origin), and when and where they are imported will serve for VAT purposes as for customs duty purposes, although it may be necessary to make clear that the act of importing occurs within the territory of the state for VAT purposes to avoid any legal problems. Customs regimes, such as free ports, duty-free shops, and tax-free zones can be applied readily to VAT on this basis, the zones being regarded as outside the territory of the state.

5.1 Imported goods

Because the VAT system depends on the levying of tax on every person when the person acquires goods, it is logical that when that person acquires goods by importation VAT should also be charged. VAT will be collected by customs and excise department on entry for home consumption of imported goods in terms of the Customs and Excise Management Act. Section 3 states that the, Value added tax shall be imposed and payable on taxable supplies and taxable imports. Whereas section 4(a) provides that the person liable to pay value added tax, in the case of a taxable import, the importer;

5.1.1 Value of import for VAT purpose

Section 9 of the VAT Act provides that, the value of an import of goods shall be the sum of -

(a) the value of goods for the purposes of customs duty under the East African Customs Management Act, whether or not duty is payable on the import;

(b) the amount of any customs duty payable on the import; and

(c) to the extent not included under paragraph (a) or (b) in respect of-

i) the cost of insurance and freight incurred in bringing the goods to Mainland Tanzania; and

ii) the amounts of any tax, levy, fee, or fiscal charge other than customs duty and value added tax payable on the import of the goods.

5.1.2 Payment and collection of value added tax on imports

Under section 8(1)(a),the value added tax payable on a taxable import is to be paid-where goods are entered for home consumption in Mainland Tanzania, in accordance with the provisions of this Act and procedures applicable under the East African Customs Management Act; The Commissioner General shall collect value added tax due under this Act on a taxable import at the time of import.(section 8(3)

5.2 Imported Services

VAT on imported services is accounted for by the “reverse charge” method. Any services sourced from abroad, which would be taxable if obtained from a Tanzanian supplier, are subject to this reverse charge. Relevant services are treated as being supplied both by and to the importer. The notional calculated output tax must be accounted for, but the same value may be deducted as input tax in the same tax period, subject to any restriction imposed by a partial exemption method. The effect of the procedure is that there is no financial impact on businesses which make only taxable supplies. Businesses which make exempt supplies will bear the tax on imported services in the same way and to the same extent as if they had obtained the services in Tanzania.

Businesses which make only exempt supplies, and which consequently cannot register for VAT under normal circumstances are obliged to register if the value of their imported taxable services exceeds the registration threshold.

Legal authority

Section 68(2) of the Act provides that,the value added tax payable by the purchaser of a taxable supply of imported services shall be output tax and input tax of that person, and the purchaser shall not be allowed an input tax credit for that supply unless he has accounted for the output tax in the same Value added tax return in which the input tax credit is claimed.

This means that, a taxable person who acquires imported services shall treat such supplies as:

(i) Supply by the taxable person and should impose output tax as the case may be; and

(ii) Supply to the taxable person and treat amount of output tax so imposed as input tax of the taxable person.

Section 2 of the Act define imported services as services supplied to a taxable person if the supply of the services is not made in the United Republic as determined under this Act. Therefore it is service acquired from person residing outside Tanzania Mainland.

Self-Examination Questions

Question 1

Explain five circumstances where input VAT is not claimable

Question 2

BH Trading Limited is a company which is registered for value added tax (VAT). The company entered into the following transactions in the month of May 2018:

(i) Sales to VAT registered customers were Tshs 200,600,000 out of which Tshs 100,600,000 were standard rated and the balance zero rated.

(ii) Sales to unregistered customers were Tshs 60,500,000 all standard rated.

(iii) Standard rated purchases from registered customers amounted to Tshs 141,600,000 (VAT inclusive), whilst purchases from unregistered customers amounted to Tshs 10,600,000 out of which Tshs 9,080,000 were standard rated and Tshs 1,520,000 exempted.

(iv) Standard rated expenses amounted to Tshs 2,526,000 comprising:

Entertaining customers	990,000
Motor car expenses	1,005,000
Telephone bills	121,000
Stationery	250,000
Utility bills	160,000

Tshs 32,000 of the utility bills were incurred in respect of a company house in which the company's Managing Director is accommodated.

(v) The company sold standard rated furniture which was excess to its requirements for Tshs 10,620,000 (VAT inclusive).

(vi) The company acquired a motor car at a cost of Tshs 13,920,000 (VAT inclusive) and a delivery van at a cost of Tshs 20,600,000 (VAT inclusive). VAT on the two vehicles was charged at the standard rate and both vehicles are used wholly and exclusively for business purposes.

(vii) The company wrote off a debt of Tshs 1,180,000 and Tshs 560,000 in respect of a standard rated invoice of unregistered customers which were due on 30 June 2016 and on 31 December 2017 respectively.

Unless specifically stated, all the above persons are registered for VAT and the transactions are stated exclusive of VAT.

Required:

Calculate the VAT payable in respect of the month of May 2018

Question 3

State any **four (4)** conditions which must be met for a business to claim bad debt relief. (4 marks)

Question 4

Maziku Limited is a cooking oil processing company located in Ndala, Tabora region, and is registered for value added tax (VAT). Maziku Limited entered into the following transactions in the month of September 2018:

1. Sold taxable supplies to customers as follows: Sales to VAT registered customers Tshs 3,835,000 (VAT inclusive) and Tshs 675,000 to unregistered customers.
2. Bought a brand new pick-up from Toyota at Tshs 3,250,000.
3. Bought stationery worth Tshs 65,000 from suppliers who are not registered for VAT.
4. Entertained major customers at a local hotel at a cost of Tshs 246,100.
5. Bought ground nuts from local farmers at a cost of Tshs 1,250,000.
6. Paid for electricity and telephone at Tshs 32,140 and Tshs 44,100, respectively.
7. A consultant on production processes was hired from South Africa. The consultant has no local office; as a result he is not registered for VAT. He invoiced Tshs 1,650,000 for the work done.
8. Bought an EFD machine from BMTL Suppliers at Tshs 175,800.
9. Received a deposit on sale to a customer amounting to Tshs 465,000.

   Unless specifically stated, all the above persons are registered for VAT and the transactions are stated exclusive of VAT.

Required:

Calculate the VAT payable or any excess carried forward for the period

Question 5

State three types of expenditure on which the input VAT payable by a registered trader is treated as 'blocked' and therefore irrecoverable

Answers to Self-Examination Questions

Answer to SEQ 1

The taxable person may not be allowed to claim deduction of input tax he/she has so incurred under the following circumstances:

(i) Where the input tax is directly attributable to an exempt supply.

(ii) Where the input tax deduction claim is not supported by the required documentary evidence.

(iii) Where the input tax is time barred. Tax is incurred more than six months before the date of claiming deduction.

(iv) Input tax incurred on purchase of motor vehicles for carriage of passengers or cargo for other than commercial reasons.

(v) Input tax incurred on provision of business entertainment.

Answer to SEQ 2

Output VAT		
Sales to registered customers:		
Standard rated sales		18,108,000
Zero rated sales		
Sales to unregistered customers		10,890,000
Sale of furniture		1,620,000
Total output tax		**30,618,000**
Input VAT		
Purchases from registered traders	21,600,000	
Purchases from unregistered traders(irrecoverable)	-	
Standard rated expenses:	-	
Entertaining customers		

(irrecoverable)	-	
Motor car expenses(irrecoverable)	-	
Telephone bills (irrecoverable)	21,780	
Stationery	45,000	
Utility bills	23,040	
Utility bills for directors accommodation (irrecoverable)	-	
Motor car (irrecoverable)	-	
Delivery van (	3,142,373	
Bad Debt relief:	-	
Invoice due on 30 June 2016 (18/118 ×1,180,000)	180,000	
Invoice dated 31 December 2017 (Does not qualify)	-	
Total Input Tax		**25,012,193**
VAT payable		**5,605,807**

Answer to SEQ 3

The following conditions must met for a business to claim bad debt relief:

(1) A supply of goods and services must have been made for consideration in money

(2) Output VAT must have been accounted for and paid by the supplier,

(3) The whole or part of the debt must have been written off as bad in the records of the supplier,

(4) At least eighteen months must have elapsed since the time when the payment was due.

Answer to SEQ 4

VAT payable or any excess carried forward for the period

Output tax			
Sales for the month			
Registered Customer	3,835,000	18%/118%	585,000
Unregisterd Customer	675,000	18%	121,500
Consultants	1,650,000	18%	297,000
Deposit	465,000	18%	83,700
			1,087,200
Input tax			
Capital goods – Toyota	3,250,000	18%	585,000
Stationery	65,000	18%	11,700
Entertainment	246,100	18%	44,298
Groundnuts	1,250,000	Exempt	-
Electricity and telephone	76,240	18%	13,723
Consultants	1,650,000	18%	297,000
EFD Machine	175,800	Exempt	-
			951,721
VAT payable			135,479

Answer to SEQ 5

a) An acquisition of goods, services, or immovable property, to the extent that it is used to provide entertainment, unless the person's economic activity involves providing entertainment in the ordinary course of the person's economic activity;

b) An acquisition of a membership or right of entry for any person in a club, association, or society of a sporting, social, or recreational nature;

c) An acquisition or import of a passenger vehicle, or of spare parts or repair and maintenance services for a passenger vehicle, unless the person's economic activity involves dealing in, hiring out, or providing transport services in passenger vehicles and the vehicle was acquired for that purpose. The restrictions are discussed in more details below

SECTION G

CUSTOMS

G1

STUDY GUIDE G1: CUSTOMS

Get Through Intro

Customs departments play a major role in collecting government tax revenues. The taxes come from taxing imported and exported goods. While the value of exported goods can be easily determined by the exporting country, the value of imported goods is a bit challenging to all customs departments in the world.

To resolve the valuation faced by custom, customarily six methods of calculating value of imported goods have been agreed internationally. These are transaction value of imported goods, transaction value of identical goods, transactional value of similar goods, deductive method, computed method and fall back method.

This Study Guide deals with operation of customs tax laws, application of customs valuation methods and computation of customs taxes.

Knowledge of customs tax laws is important in ensuring compliance with the customs tax laws and efficient administration of the laws.

Learning Outcomes

a) Describe sources of Customs Law
b) Describe the objectives and scope of cooperation in the East Africa Customs Union
c) Explain customs entry and clearance procedures for imports
d) Explain the customs entry and clearance procedures for exports
e) Explain the administration of bonded and customs warehouses
f) Differentiate between prohibitions and restrictions
g) Describe the rules of origin in the East Africa Customs Union
h) Apply Customs Valuation methods
i) Calculate Duties and Taxes collected through customs
j) Explain Customs procedures for prevention of smuggling
k) Determine offences in customs operations
l) Describe recovery measures used to collect unpaid duties

Describe the sources of customs law; objectives and scope of cooperation in the East Africa Customs Union; and explain customs entry and clearance procedures for imports.

[Learning outcome a, b, and c]

1. Sources of Customs Law

Customs and excise department of Tanzania Revenue Authority collects all import and export taxes. These taxes include excises duties, value added tax on imports, import duties and export duties. Consequently, the department implements Value added tax Act, 1997; Electronic Fiscal Devices Act, 2010; The East African Community Customs Management Act, 2004; The East African Community Customs Management (Amendment) Act, 2011, The Excise Management and Tariff Act, Chapter 147; Protocol on the Establishment of the East African Customs Union, The East African Community Customs Union (Rules of Origin) Rules, Electronic Fiscal Devices Regulation, 2010, East Africa Community Customs Management (Duty Remission) Regulations, 2008; East Africa Customs Management Regulations, 2010; East Africa Customs Management (Compliance and enforcement) Regulations, 2012. In addition, practice notes, case laws and directives made by the council of East Africa Community and relevant principles of international laws are sources of customs tax laws. Throughout this study guide, any reference to section refers to the East African Community Customs Management Act 2004. With exception of the value added tax laws, other customs tax laws are implemented at the East Africa Community level because all customs in the community are managed under the East Africa Community Customs Management Act, 2004. Therefore all East Africa community Partner states such as. Tanzania, Rwanda, Burundi, Kenya and Uganda are required to abide by these laws.

2. Objectives and scope of cooperation in the East Africa Customs Union

A Protocol for the Establishment of the East African Community Customs Union was signed by the three East African Heads of State on 2 March 2004 in Arusha, Tanzania.
The Republics of Rwanda and Burundi joined the Customs Union in 2008 and started applying its instruments in July 2009.

Objectives of the Customs Union

The objectives of the EAC Customs Union are:

- To further liberalise intra-regional trade in goods on the basis of mutually beneficial trade arrangements among Partner States;
- To promote efficiency in production within the Community;
- To enhance domestic, cross-border and foreign investment in the Community; and
- To promote economic development and diversification in industrialisation in the Community.

Scope of Co-operation

Co-operation will apply to any activity undertaken by the EAC Partner States in the field of Customs Management, and includes the following:

- Customs administration;
- Matters concerning trade liberalisation;
- Trade related aspects including the simplification and harmonisation of trade documentation, customs regulations and procedures;
- Trade remedies;
- National and joint institutional arrangements;
- Training facilities and programmes on customs and trade;
- Production and exchange of customs and trade statistics and information; and
- The promotion of exports

3. Customs Entry And Clearance Procedures For Imports

3.1 Import Procedures

Reporting procedures for means of conveyance

There are various Customs formalities to be accomplished when goods are brought into a Customs territory in order to ensure compliance with Customs law. These are the operations that must be carried out by both the persons concerned with the goods and by Customs in order to comply with the statutory or regulatory provisions which Customs has responsibility to enforce. However as the goods arrives from the foreign destination it is first essential to identify the means of conveyance used to bring those goods and the reporting procedure of such means which entails the control purposes from the Customs perspective as the control of goods and vessel under Customs control is very important for the sake of combating revenue loss.

REPORT OF VESSELS, AIRCRAFTS, AND VEHICLES

Inward report of vessels, aircrafts, and vehicles

This is a Customs procedure where a master of every aircraft or vessel arriving from a foreign port at any port, make report of such aircraft or vessel, and of its cargo and stores, and of any package for which there is no bill of lading, to the proper officer on the prescribed form and in the prescribed manner.

Outwards report of vessels, aircrafts, and vehicles

This is a Customs procedure where the master or agent of every aircraft or vessel in which any goods are to be exported make a reports of such aircraft or vessel to the proper officer on the prescribed form and in the prescribed manner

All Aircrafts, Vessels and Vehicles etc, from Foreign must report at appointed ports. When reporting at appointed ports they must go straight to mooring areas and or landing or boarding areas.

Once the vessel reports, it is not allowed to depart to another port within the country unless the proper officer has granted permission to the Master.

Once the Master departs to foreign, is not allowed to call at any place within the country unless the proper officer according to the law has granted him the permission. (Section 21 (1) and (2))

The proper officer may direct the vessels or aircraft place of mooring (Section 22)

Restriction on Boarding Vessel before Proper Officer

Once arriving at the place of mooring it is the duty of proper officer to board the vessels/aircraft. The agent should know that it is only Proper Officer who is responsible to board vessels/ aircraft and the agent should facilitate such role in a manner allowed within Customs laws. In some occasion, port pilot, the health officer or any other public officer in the course of performing his duties and duly authorized, may board before the proper officer (S 23). The Act provides such exclusion, Provided that prior permission from the proper officer has been granted.

Making formal reports (S 24 of EAC Customs Management Act, 2004,

The Master of the vessel, Aircrafts or vehicle when arriving from foreign must furnish a formal report to the proper officer on arrival using the prescribed Customs forms. The report should be within 24 hours before arrivals in case of vessels and immediately after taking off from the last point of departure to the Partner States in case of Aircraft. Every report must show goods to be unloaded, in transit; transshipment and those remain in the aircraft or vessel. Goods in transit, for transshipment, and goods remaining on board for other ports must be shown separately.

Amendment of report S.24 (5)

In case of obvious error or any omission which result from accident or inadvertence, the agent may be allowed to amend the report or submit supplementary report.

The Master or Agent may ask for the amendment of the report – (Manifest) using prescribe form. He must satisfy the officer that:

i. Goods were not shipped

ii. Landed at a previous port or

iii. Over carried and landed at a subsequent Port and

iv. If over carried, have been returned to a Port in the Territory

v. Lost at sea

vi. Stolen or destroyed before arrival

All correspondences on short landed goods must be filed in the manifest file.

Each page of the report must be signed initialed, numbered and sealed together by the master or his agent, if required, signed in the presence of the proper officer.

LANDING PERMIT

Landing permit is required for goods declared as parcel using parcel list. The agent should know the time limit for the landing permit at the time of submitting it.

The information about the value, classification and taxes with respect of the goods are entered on the reverse of Landing Permit.

GOODS IN TRANSIT SHED

Due to some working environment some goods may be unloaded in a transit shed. However, Goods in a transit shed are deemed to be in the importing vessel/aircraft until they are delivered and the owner or agent shall continue to be responsible.

i. Where goods reported for discharge are not dully unloaded and deposited in a transit shed or Customs area the master/agent must pay the duty thereof unless he explain to the satisfaction of the proper officer. (Section 26)

ii. The owner of vessel or aircraft or his agent, or the transit shed owner who fails to count for the goods in ones custody commits an offence.

iii. The owner of vessel or aircraft or the owner of a transit shed is liable to pay for the reshipment or for destruction of the goods condemned.

iv. The owner or agent of an aircraft or vessel or owner of a transit shed who fails to meet the costs of reshipment or destruction of any condemned goods commits an offence.

Goods Reported to be unloaded but not unloaded:

When goods which are supposed to be unloaded and the goods are not in effect not unloaded in a transit shed the masters or agent of the aircraft or the vessel shall pay duty on the goods unless acceptable explanation is given to the proper officer.

Shipwrecked or Damaged in an accident in transit

The master of an aircraft or vessel accidentally forced to land in the East African Community States must report immediately on the cargo and stores to the nearest Customs officer or Administrative Officer. The cargo and stores of an abandoned vessel or aircraft will be subjected to seizure unless the master o agent gives satisfactory explanation to the proper officer.

In case of loss or wreck of ships or air craft master or agent of aircraft or vessels shall, with all reasonable speed make report of such aircraft or vessel and its cargo and stores to the nearest officer or administrative officer. (Section 28)

Manifest, Bill of Lading and Airway Bill

Manifest

A manifest is a list of goods by consignments to be landed at one particular port within the country. If vessel or aircraft is going to land or call at more than one port a separate manifest should be prepared.

A manifest is a report presented to Customs Department pertaining to goods being conveyed by vessel aircraft or vehicle arriving from or departing to a foreign port/airport.

The Customs Agents' Role in Manifest Section

I. To submit reports of all aircrafts, vessels and vehicles arriving from or leaving for a foreign port

II. To apply and recheck the rotation/Manifest numbers allocated by Proper Officers in respect of all vessels, aircrafts and vehicles arriving from or departing to foreign ports

III. To liase with the officers in case of amending the manifests as applied for by shipping agents/

Customs agents and submit the reasons advanced in respect of the applications in satisfaction of the Customs Laws and regulations

IV. To advise the client on the Customs Warehouse Date

V. To ensure that all documents necessary to facilitate compilation of the ships files have been submitted to Customs

VI. To compile ships files

Manifest information (the minimal)

- Ships details (Ship's name, ship's tonnage)
- Voyage details(departure/destination date, departure/ destination port)
- Owner – supplier names
- Consignee's name, address
- Description of goods (types, Weight of packages etc)
- Marks/numbers of packages,

Arrival of goods by overland route

Arrivals by vehicles

A person in-charge of the a vehicle whether carrying any dutiable or un-dutiable goods which arrives overland at a frontier of a partner state from outside the East African Community must adhere to the following procedures before unloading or depositing the vehicle or goods at the frontier port. Report his/her arrival to the Customs officer stationed at the relevant frontier port he/she enters the Partner State.

i. Fill in information in prescribed form about the vehicle and the cargo.

ii. Sign a declarations ;s to the truth of all particulars filled in the form

iii. Fully and immediately answer any relevant questions put to him/her by the proper of about the vehicle and cargo.

iv. Produce all consignment note.

v. Unless provided otherwise in the Customs laws make due entry of the vehicle and any such goods conveyed. Section 29 of the EACCMA of 2004 provides that the goods and the vehicle which are dutiable will not be removed from the Customs area until after due entry and permission to remove the vehicle and the cargo from the Customs area. A person who contravenes the above procedure commits an offence and may render the goods and vehicle liable to forfeiture.

Arrivals by International trains

With arrival by international trains the Customs area is the border railway station. The stationmaster or other person in-charge of the railway station acts on behalf of the Railway Company or corporation.

The procedure then is as follows;

i. The station master or any other person in-charge of the railway station on the arrival of the train at the port submits to the proper officer copies of invoices, consignment notes, way bills or other documents relating to the goods in wagons, which are subject to Customs control received by her/him at the station or supposed to be entered at the station.

ii. The station master or other officer in-charge of the railway station must not allow any goods to leave the Customs area without the permission of the proper office because removal of such goods without permission constitutes an offence.

iii. A station master or other person in-charge of the railway stations hall not, without written permission of the proper officer deliver to the consignee or other person's goods require to be entered at any other station.

iv. An owner or user of a private railway siding shall not receive wagons containing goods subject to Customs control into a private railway siding unless he/she is granted permission from the commissioner of Customs and excise.

v. Any person who contravenes these provisions as per section 30 of the EACCMA of 2004 may tender the goods subject into seizure.

Arrivals overland by other means

If a person arrives by land into a Partner State with any goods in his possession shall before disposing of the goods must follow the following procedure;

i. Report to the proper officer at the nearest point of entry into the Partner of State.

ii. Finish information about the goods in his/her possession in a prescribed form

iii. Declare and sign that all the particulars given in the form are true.

iv. Answer fully and immediately all question asked by the proper officer about the goods.

v. Produce all consignment notes and other documents demanded by the proper officer.

vi. Make entry of such goods unless the Customs laws state otherwise.

vii. Removal of goods received in a Customs area at any place of entry into Partner States is prohibited except with the permission of the proper officer.

viii. The commissioner however subject to conditions he/she may specify may exempt any person or a class of persons from the provisions in section 31 of the EACCMA of 2004. However contravening these provisions may render the goods in question liable to forfeiture.

Clearance by pipeline:

Pipelines are means of conveying goods such as petroleum or gas. The owners of the pipelines are like vessels and aircraft's. The procedure for arrivals of such goods is a follows;

i. The nature and quantities of goods imported or exported through a pipe line shall be recovered and reported by the operator of the pipeline in a manner the commissioner may direct.

ii. For the purpose of recording and reporting the commissioner may specify the apparatus and appliances to be used by the operators of the pipeline at their expense.

Passenger clearance

A passenger arriving from a foreign country may be required to make declaration of his/her goods (Section 46). Likewise, as for aircrafts a passenger from an aircraft or a vessel should disembark only from it at appointed place. In addition, any person including who is disembarking at that port or place; who is returning ashore, who has any uncustomed goods; the crew of an aircraft or vessel who are leaving that aircraft or vessel either temporarily or for any other reason, and wish to remove their baggage or part thereof, from that aircraft or vessel; any passenger who is temporarily leaving that aircraft or vessel and wishes to remove therefrom his baggage, or any part thereof or any other person who may be required by the proper officer to do so; should go direct to the examination baggage room and remain there until permitted removing (Section 44(2)). Then, the person can use either green or red channel to exit the port.

Definitions

Green channel means that part of the exit from any customs arrival area where passengers arrive with goods in quantities or values not exceeding those admissible.

Red channel means that part of the exit from any customs arrival area where passengers arrive with goods in quantities or values exceeding passenger allowance.

Therefore, the green channel is for passengers with nothing to declare or with baggage consisting of only goods within the prescribed passenger allowance and the red channel is for passengers carrying dutiable or restricted goods and for crew members of vessels or aircrafts (Section 45).

Explain the customs entry and clearance procedures for exports; explain the administration of bonded and customs warehouses; differentiate between prohibitions and restrictions; and describe the rules of origin in the East Africa Customs Union.

[Learning outcome d, e, f, g and h]

4. Customs Entry And Clearance Procedures For Exports

Definition

Exportation means the movement of goods from one country to another. In accordance with the EACCMA, 2004 S.2 (1), the term export means to take or cause to be taken out of a Partner State. There are three types of exportations, namely outright exportation, temporary exportation and re-exportation. Transit and Transshipment are also considered as exports.

Categories of exports

Outright exportation

This covers goods which are exported out of the country with the intention to remain there permanently or to be consumed in those foreign countries e.g manufactured goods like sugar, coffee, tea, nuts etc.

Temporary exportation
This covers goods which are exported out of the country for special purposes and will be brought back e.g. goods exported for renovation, exhibition or entertainment and declared on the respective procedure code whereby the re-importation certificate is issued as confirmation that the goods have left the country and may be re-imported.

Re–exportation
Re–exportation is the Customs procedure whereby goods that were imported for temporary use or purpose are to be exported after the end of the intended activities, examples are goods for exhibition or entertainment. Such goods have to be entered properly and be secured with a Customs security bond.
Re-exportation is normally checked against the preceding entry to ensure that the re-export entry match/tally with the previously temporary importation entry.

Export process
For goods to be exported they need to be entered for export. Once the Customs agent makes an entry then goods are to be physically examined before being loaded for export. The export process is terminated i.e comes to an end, when vessel carrying goods for export leave the boundary of Partner States to foreign destination.

Export documentation and declaration
Before export of goods, the owner of the goods is expected to formalize all the procedure for exports. These include the following;

(i) has to obtain an export license upon the meeting the business requirements.

(ii) All goods to be exported should be loaded onto any aircraft or vessel departing to a foreign part within the boundaries of the port.

(iii) The goods to be loaded for export should be entered on *the export entry (SAD)* in quadruplicate copies and the owner shall be required to furnish full particulars, supported by documentary evidences. i.e. Commercial invoices, permits, receipts etc that relate to the goods for export.

(iv) The entry must show the following details:

   a. Name and address of exporter.
   b. Name and address of importer.
   c. Name and address of Customs agent.
   d. Country of destination.
   e. Commodity code and description of goods.
   f. Value of goods and total amount of duty payable.
   g. Marks and number of transporting vessel, aircraft, or vehicle.
   h. Total number of packages
   i. All other information as appeared in SAD

(v) The goods to be exported are grouped into three categories of which are to be entered separately according to Customs procedure codes:- (CPC) as shown below:

   - Exports of domestic goods free of duty.
   - Exports of domestic goods liable to export duty.
   - Re-exportation of goods not under drawback.

Other trade related documents are also important as they may be required when goods arrives at the intended destination. These include certificate of origin, health certificate, certificate from Standard Bureau etc

Conditions for exports

Loading of goods on any aircraft or vessel or vehicle departing to a foreign should be done subject to the permission of the proper officer or conditions as he/she may impose.

The following conditions must be fulfilled before loading any aircraft or vessel:-

(a) Goods shall only be put on board any aircraft or vessel when they are dully entered.

(b) Goods shall only be put on board any air craft or vessel within the time prescribed by the Commissioner.

(c) Goods shall only be put on board any aircraft or vessel from an approved place of loading or from a sufferance wharf.

(d) Goods shall only be put on board any aircraft or vessel after an entry outward of such vessel has been made.

(e) Goods shall be put on board any vessel to be loaded on to any aircraft or other vessel only when such goods may be directly put on board such aircraft or other vessel.

(f) Goods put on board any vessel to be loaded on to any aircraft or other vessel within the limits of the port.

The agent should be aware that, no goods that have been put on board any aircraft or vessel for export should be discharged at any place within the Partner States without a written permission of the proper officer. This is an offence as per the provision of EACCM Act.

Verification and release of goods for export

The Document Processing unit may, before processing of export entries refer them to the Customs port of loading or entry for any necessary clarifications. The Unit shall ensure that the declarations in the registered entry conform to the verification reports.

In case of restricted exports, they must be covered by the appropriate export permits while for goods on which drawback is to be claimed, the particulars on the entry shall be compared with the particulars of the respective import entry for conformity.

There should be proper manning of entry gates by Customs enforcement Officers, to confirm the correct verification report and container details before allowing export containers into the port.

All exports are subject to Customs control, hence a Customs Officer has the power to examine such goods, but any other person has to seek for authority from the Commissioner of Customs to intervene in any way on such goods. Goods shall be examined at the risk and expense of the owner, thus the owner is required to unpack, sort, pile, or otherwise prepare the goods for examination. Exports are referred for physical examination or scanning before they are exported. Examining Officers must ensure that the supporting documents have correct information in respect to quantity, weight and value.

Upon satisfaction that the declaration is correct in every aspect, an examination account is to be put in the Customs system (ASYCUDA/SIMBA) for the export entry to be passed and if liable to any export duty its then collected. If duty is advalorem then The value of goods for export shall include-

- the cost of the goods;
- transport and all other charges up to the time of delivery of the goods on board the exporting aircraft or vessel, or at the place of exit from the Partner State.
- If the cost of the goods cannot be determined under the above, the cost of similar or identical goods exported from a Partner State at about or the same time shall apply.

After payment of export duty if any, export entries shall be referred to the officer in-charge of the export station for the purpose of allocating officers to witness loading and sealing of containers at the exporters premises.

After the verification process, all packages in the consignment are to be sealed with Customs tamperproof seals before leaving the manufacturer's premises.

Exportation of Bonded Goods:-

At the Customs port of exportation, the Customs Officer has to confirm exportation by endorsing the hard copies of the export entry with export certification. Similar certification of shipment account is to be posted against the respective customs entry.

This account together with the Certificate of Export will be used by Security Bonds Management office for bond cancellation, or at the border, in the case of automatic acquittal of the bond.

Agent has to make sure that goods loaded for export are loaded in presence of customs officer as no export cargo shall be received at Export Stations without evidence that it was loaded under Customs supervision. At export stations, releasing Officers have to check and satisfy themselves that seals have not been tampered with.

If seals are interfered with, 100% physical verification must be done before release for export.

At all times the releasing Officers have to endorse their findings in form of an examination account.

Once satisfied that the cargo is correctly entered as per inspection results its released with an online Release Order and issue a certificate of export.

Certificate of Exports

A Certificate of export is issued upon confirmation of exportation by the exporter/Clearing agent presenting endorsed copy of the original bill of lading from the shipping line confirming that the goods were exported.

The proper Officer has to confirm both the information on the Bill of Lading and the Customs entry.

If the information matches/tallies then the Officer issues a certificate of export to allow the clearing agent cancel his security bond in case of bonded goods.

Certificates of Origin

Certificates of Origin are issued to facilitate privileged Customs treatment of goods exported from a Partner State to countries with which the Community has preferential trading agreements.

These Certificates of Origin are issued in respect of qualifying goods upon payment of the appropriate fees.

The certification of Certificate of Origin is done by Officers specially appointed for that purpose and whose stamps and signatures are registered and circulated to the respective trading partners/blocs.

Where the provisions of the trade agreement allow retrospective issuance of Certificates of Origin in respect of goods exported without such a certificate, then the certificate may be issued provided all the documentation is in order.

A Certificate of Origin can only be issued by the Officer authorised to sign it after confirmation of exit of goods and It cannot be substituted by any other document, except where the export destination or Consignee has changed and this should be done before the goods are exported and approval is granted by the Officer in-charge of administering the rules of origin.

Trade agreements provide for co-operation between trading partners in the investigation of fraudulent claims on certificates of origin. Accordingly, requests made for assistance should be fast tracked with thorough investigations.

The designated Officer should ensure that requests for assistance under the terms of a trade agreement are expedited and that officers of sufficient seniority and experience are appointed to undertake the investigations. The Investigation findings are to be conveyed to the foreign Customs Authorities through the office of the Commissioner of Customs as a matter of acceptable operational protocol i.e (exchange or information.

Procedures for Outward Clearance of means of conveyance

The master or agent of every aircraft/vessel or vehicle in which any goods are to be exported, should make entry outwards to the proper officer on the Customs prescribed form. Such entry outwards should only be made after the whole of the cargo reported for discharge has been discharged.

Goods which have been put on board any aircraft or vessel for export, or for use as stores, or as passengers' baggage, should not be discharged at any place within the Partner States, except by written permission of the proper officer and in accordance with such conditions as he or she may impose.

For the case of a vehicle, A person in charge of a vehicle or not departing from a partner state, whether or not such vehicle is conveying goods, should depart through the appointed port under Section 11 and before departing he/she should do the following:-

(a) Report his/her intended departure to Customs officer.

(b) Furnish on the prescribed forms all information related to the vehicle and goods for exports.

(c) Fully and immediately answer all relevant questions put to him/her by the proper officer.

(d) Produce any consignment notes or any relevant documents demanded by the proper officer.

(e) Make due entry of the vehicle and goods for exports.

Export Promotion Schemes

Export promotion schemes are schemes designed to promote production of goods for export. Partner States have agreed in the protocol for the establishment of customs union to engage in some of the export promotion schemes with a motive to promote trade. Some of the schemes are Manufacturing Under bond, Export processing zones or special economic zones, Inward/Outward Processing.

Manufacturing Under Bond

Manufacturing under Bond is a facility extended to manufacturers to import plant, machinery, equipment and raw materials tax free, for exclusive use in the manufacture of goods for export

The EACCMA empowers the Commissioner of Customs to license any person who wishes to manufacture goods under bond subject to condition he/she may impose.

Conditions for licensing

i. Application for a licence to be made in a prescribed form specifying the purpose for which each building, room, place or item of plant is to be used.
ii. A security to be furnished as the Commissioner may think appropriate.
iii. Suitable office accommodation to be provided to Customs officer.
iv. Premises for manufacturing process must be approved by commissioner as to suitability and safety. The Customs officer can inspect the premises to that effect.
v. A prescribed annual licensing fee to be paid.
vi. No alterations to be made on the premises without prior permission of the commissioner
vii. violation of the of the terms or conditions for licensing is an offence and one who commits such offence shall be liable on conviction to a fine not exceeding five thousand dollars or to imprisonment for a term not exceeding three years or to both; and any goods in respect to which an offence has been committed shall be liable to forfeiture.

Responsibility of a bonded factory Licensee

i. Make an entry, prior to commencement of manufacturing under bond, in the prescribed form specifying the purpose for which each building, room, place or item of plant is to be used.

ii. Provide office accommodation and scales, measures and other facilities materials or just weights, for examining and taking account of goods and for securing them as the proper officer may reasonably require;

iii. Keep a record of all types of plant, machinery and equipment, raw materials and goods manufactured in the factory and keep that record at all times available for examination by the proper officer;

iv. Provide all necessary labour and materials for the storing, examining, packing, marking, coopering, weighing and taking stock of the goods in the factory whenever the proper officer so requires.

v. Non- compliance with set conditions may result into suspension, revocation or refusal to issue a license by the Commissioner

Export Processing Zones

EPZs are specialized areas in the EAC Customs Union where imported goods are offered duty free treatment for purposes of processing or manufacturing for export under given conditions.

According to the EACCMA an export Processing Zone is a designated part of the Customs territory where any goods introduced are generally regarded for the purpose of import duties and taxes as being outside the Customs territory but are restricted by controlled excess and to which benefits provided under the Regulations made under Article 29 of the East African Community Customs Union Protocol.

Application, Licensing and approval of EPZ

Applications for investment in any EPZ, must be made in the first instant to the relevant Authority.

For operational purposes, export processing zones are considered to be foreign territories for the purposes of the application of the Customs and Excise Act. However, the removal of goods from port to an EPZ enterprise must be covered by a bond. Any goods leaving the Zone into the Partner State must be considered as imports and are subject to the importation rule and duty. Local goods supplied to as EPZ enterprises are considered as exports and must comply with all conditions governing such exports.

The Objectives of the EPZ

i. To attract export led industrialization for diversification and enhancement of competitiveness.

ii. To earn more foreign currencies.

iii. To increase employment and develop the capacity of skilled labour.

iv. To benefit from technology transfer and

v. To process more local materials for export.

Obligations of EPZ investors

i. To produce for Export markets.

ii. To provide details of all raw materials received at the site of manufacturing during the previous quarter of the year.

iii. To produce semi-finished or finished products including by products exported or off-loaded in the Customs territory.

iv. To provide details of waste-products and how they are disposed.

v. To provide accurate records of losses through evaporation, spillage, leakage or other causes.

vi. To produce balances of law materials and semi finished products including stocks of by products at the premises of manufacture and transit.

vii. To facilitate inspections and examination by the Customs.

viii. To take all measures to reduce the fears of task cheating in a way that Tanzania Investment Centre cannot provide.

Treatment of Goods Deposited in EPZ

Section 191(2) required all goods imported for EPZ to be entered in SBE together with cargo receipt and lending account book and a bond in the form of EPZRI shall be executed. The goods must be destined in sealed containers, boxes or vehicles except in case of exceptionally bulky loads. Goods imported to EPZ from the custom territory must be treated in the same manner as if such goods were

Duty Remission

Section 140. (1) Of the East African Community Customs Management Act 2004 provides that The Council may grant remission of duty on goods imported for the manufacture of goods in a Partner State.

The Council may prescribe regulations on the general administration of the duty remission under this section.

The manufacturer, and the approved quantity, of the goods with respect to which remission is granted under this section shall be published by the Council in the Gazette.

Section 141of the same Act provides that where any goods are lost or destroyed by accident

Either on board any aircraft or vessel; or in removing, loading, unloading, or receiving them

into, or delivering them from, any Customs area or warehouse; or in any Customs area or warehouse, before the goods are delivered out of Customs control to the owner, then, if the Commissioner is satisfied that such goods have not been and will not be consumed in a Partner State, the Commissioner may remit the duty payable in respect of the goods.

Duty Draw Back

Most administrations have in place procedures which help promote export trade and are in the interest of the national economy. Drawback is one such procedure. This procedure grants repayment of import duties and taxes paid on:

- Goods used in the processing or manufacture of exported products,
- Materials contained in the goods or consumed in the manufacture of the exported products, or
- Imported goods re-exported in the same state.

The repayment may be partial or total. Drawback is one of the several procedures which provides relief from duties and taxes for the manufacture of exported goods and is extensively used. Some administrations may allow it in combination with other procedures like inward processing, temporary admission or Customs warehouses.

“Drawback procedure” means the Customs procedure which, when goods are exported, provides for a repayment (total or partial) to be made in respect of the import duties and taxes charged on the goods, or on materials contained in them or consumed in their production.

Economic benefits

The imported goods are used to process or manufacture goods for export by the domestic industries. The use of domestic labour and processing or manufacturing of goods add value to the finished goods for export. The repayment of duties and taxes paid on the imported goods enables domestic industries to offer the goods at competitive prices on international markets.

Some administrations restrict the categories of goods qualifying for drawback. This is usually an economic consideration and is designed to encourage the use of equivalents of imported goods which are produced within the country by domestic industry.

Where it may be difficult to identify certain exported goods as being those that were originally imported or those resulting from the processing of imported goods, administrations should allow the exportation of equivalent goods (e.g. compensating goods equivalent in all respects to the goods which should normally have been re-exported) and apply the drawback procedure to repay import duties and taxes where goods or materials are replaced by equivalent goods or materials. This is a practice which is recommended in this Chapter.

Countries wishing to encourage trade through free zones in their territory may also apply the drawback procedure to goods that are re-exported into these zones.

Usually goods imported with the intention to re-export them, other than those used for processing or manufacture, are not permitted to be used during their stay in the Customs territory. If such use is allowed, administrations usually have provisions under which the amount of drawback granted is reduced according to the extent of the resulting depreciation.

Some administrations use the term drawback for refund of taxes on imported goods that are not according to specification and are returned to the seller, or goods used in manufacture for home consumption, or imported goods that are obsolete, etc. The procedure covered by this Chapter does not relate to such goods. This issue is covered in Standard 4.19 of the General Annex.

The drawback procedure will not apply to repayment of or relief from other taxes (e.g. sales tax, value added tax) or to items which may be aids to the manufacturing process that are granted relief or repayment under other provisions.

Other economic benefit of the Duty Drawback System of drawback procedure offers distinct benefits to national administrations and interested persons in that it:

- Generates domestic economic activities,
- Provides for revenue protection on imported goods released into the Customs territory, and
- Offers options to interested persons when other procedures such as temporary admission cannot be applied to the goods.

When Customs administers the drawback procedure by implementing modern control techniques of selective verifications, risk assessment of users, post-audits of users' records and electronic data exchange and transfer of payments, drawback can be well managed and offers the full array of economic incentives to national economies. (See Chapter 6 of the General Annex and its Guidelines.)

Interested persons have import options regarding whether to make the financial commitment to pay the duties and taxes and wait for repayment to be completed under drawback after the goods are exported, and whether this affects the competitive pricing of exported goods.

Inward /Outward Processing

The Commissioner of Customs is given power by the law to allow temporarily importation or exportation of goods for processing operations free from tax provided that the ownership of such goods shall remain to the exporter, and importer shall only process them under contract. The Commissioner may also allow the importation of equivalent goods to replace the temporarily exported goods for outward processing.

Inward processing means the Customs procedure under which certain goods can be brought in a partner state conditionally exempted from duty on the basis that such goods are intended for manufacturing, processing or repair and subsequent exportation.

Procedure of operation:

The operator shall apply for authorization to the commissioner in a prescribed form to carry out the inward processing operations. The application detailing the intended inward processing shall be made in advance prior to importation of the goods subject to the process.

Conditions for granting an authorization

i. The applicant offers the necessary guarantee for the proper conduct of the operation

ii. The administrative arrangements and supervision of the process are not disproportionate to the economic needs of the applicant.

iii. The applicant is established in the community except where imports of non-commercial nature are involved.

iv. The imported goods can be identified in the processed products.

v. The applicant has provided Customs security.

Entry and examination of goods

Goods imported for inward processing shall be entered in Customs prescribed form on production of:

(a) Original inward processing authorization

(b) Original invoices and other supporting documents.

The proper officer shall examine such goods at the port of entry or at the owners premises before release for inward processing.

The person authorized shall keep all records of the inward processing activities and the records shall indicate:

i. The description of quantity of goods entered for the procedure.

ii. Date of importation.

iii. Details of processing.

iv. Correct amount of duty and taxes payable.

v. Disposal of goods and waste or scrap or by-products.

vi. Compensating products obtained.

Time limit for inward processing:

Inward processing procedure shall be terminated upon:

(a) Re-exportation of the compensating product in one or more consignments within a period of one year.

(b) Re-exportation of the goods in the same state as imported immediately.

(c) Release of processed products to circulation under duty relief.

(d) Placing the goods in free zones.

(e) Entered for home consumption

However, the commissioner may prescribe specific time limit for in-ward processing.

Exportation of compensating products:

The goods may be exported through a Customs office other than the office through which the goods under in-ward processing were imported, either in full or in parts under separate entries

Compensating products entered for home consumption:

When goods placed under in-ward processing are entered for home consumption either compensatory products or goods in an unaltered state, the import duty shall be computed on the basis of the nature, quantity, Customs value and duty rate applicable to the goods at the time they were entered for in-ward processing

Outward processing

Outward processing means the Customs procedures under which goods which are in free circulation in a partner state may be temporarily exported for manufacturing, processing or repair outside the partner state and then re-imported.

The Commissioner shall only authorize goods to be exported temporarily from the partner state when:

a) The exporter confirms that the compensating product shall result from the processing operation
b) The outward processing procedure does not affect the interest of the partner state
c) The compensating products shall be re-imported within a period of one year from the date of export

During re-importation, the compensating products may be re-imported through a Customs office other than the Customs office through which the goods were exported either in full or in partial consignment under separate entries. Goods may also be re-imported in an un-altered state.

The imported compensating products or unaltered goods may be granted total or partial relief from payment of duty when are cleared for home consumption in the name of

(a) An authorized person

(b) Any person with the consent of the authorized person

(c) Where the re-imported goods were repaired and such repair could not have been undertaken in the Partner States

(d) Equipment or other goods were added to the exported goods that could not be added within the partner state.

Processing or manufacturing was done on the re-imported goods and the goods exported were the product of, and originated within the Partner States.

5. Administration Of Bonded And Customs Warehouses

Warehousing means to deposit or to cause imported goods to be deposited. The following goods shall not be warehoused- the East African Community Customs Management Regulations, 2006 sec 64)

(i) Acids for trade and business;
(ii) Ammunition for trade and business;
(iii) Arms for trade and business;
(iv) Chalk;
(v) Explosives;
(vi) Fireworks;
(vii) dried fish;
(viii) Perishable goods;
(ix) Combustible or inflammable goods except petroleum products for storage in approved places;
(x) Matches other than safety matches;
(xi) Any other goods which the Commissioner may gazette.

Types of warehouses

There 2 types of warehouses

(i) Bonded warehouses
(ii) Customs warehouses

Bonded Warehouses:

A bonded warehouse is a place (normally, though not always, a building) licensed by the Commissioner General for the deposit and storage of dutiable goods. The purpose is to allow goods to be stored under official supervision before the payment of duty and that duty should become payable only when the goods are taken out of the warehouse for consumption or use in Tanzania. It is warehouse or other place licensed by the Commissioner for the deposit of dutiable goods on which import duty has not been paid and which have been entered to be warehoused; Bonded Warehousing is one of the measures being implemented by the

(i) Customs and Excise Department to facilitate trade, which is one of its functions.

The other functions are:

(ii) Revenue collection
(iii) Enforcement of prohibition and restrictions and
(iv) Compilation of trade statistics.

Bonded Warehousing creates conducive environment to utilize the import capacities to the maximum and hence minimize the cost of importation. The facility helps to improve the liquidity position of the importers as payment of import duties is made on small quantities withdrawn from the bonded warehouses depending on their needs instead of paying for the whole consignment at the time of importation. Also re-exportation of imported goods can be done without fiscal obstacles Proper Management of the facility is very important, as it may become a source of revenue loss to the government due to abuse by unscrupulous importers.

Advantages Of Bonded Warehouse

(i) Availability of goods for trade in stock.
(ii) Creation of employment to the community.
(iii) Assurance to small traders of keeping their goods while looking gor the market.
(iv) Assurance to the Government to collect tax on imports.
(v) **DISADVANTAGES OF BONDED WAREHOUSE**:
(i) The traders may get loss on trade due to inflation, and damages.
(ii) A lot of tax revenue is tied up in the stock of goods thus failure to get a real money.
(iii) High cost of control i.e. administrative and maintenance cost.

T**YPES OF BONDED WAREHOUSE**

Bonded warehouses are approved and licensed as either:

(i) General bonded warehouses for the deposit of dutiable goods generally (i.e. those belonging to any person); or
(ii) Private bonded warehouses for the deposit of dutiable goods belonging to the licensee only. (Warehousing goods which are the property of the **warehouse keeper**.)

WAREHOUSE KEEPER: Is a holder of a license granted in respect of a bonded warehouse

DUTIES OF THE WAREHOUSE KEEPER.

It is the duty of every bonded warehouse licensee to provided/do the following:

(i) Provide an office accommodation for the bond office.
(ii) To provide all the necessary labour, facilitate examination of goods In the warehouse where never required.
(iii) Keep record of all goods warehoused such that will be available at all times for examination by Customs officer.
(iv) Stack and arrange goods in the warehouse such that access to and examination of every package is possible, and that the package marks are clearly visible at all time, also maintain sack cards.
(v) Maintain the packages in the warehouse in proper state of repair.
(vi) Account for all the warehouse goods to the satisfaction of the
(vii) Account for all the warehouse goods to the satisfaction of the collector.

APPROVAL AND LICENCING

The approval and licensing of bonded warehouses is at the discretion of the Commissioner General after application by the owner. In considering an application for approval of a bonded warehouse, the Commissioner General is obliged by law to have particular regard to:

(i) the financial standing of the applicant;
(ii) the amount of revenue involved in the goods proposed to be warehoused;
(iii) the situation of the proposed warehouse;
(iv) the security arrangements at the proposed warehouse; and the bonded warehouse facilities already available to the public in the area.

Unless he is fully satisfied on all these counts, the Commissioner General will refuse to approve and license the place as a bonded warehouse.

CONDITIONS FOR LICENSING BONDED WAREHOUSES
General Conditions

(i) An application for the licensing of premises as a Licensed Bonded Warehouse shall be made to the Commissioner in Form C22. The application shall be accompanied by a plan of the premises and its situation in relation to other premises and thoroughfares.

(ii) The Commissioner may, subject to the fulfillment of these conditions or any such other conditions as are prescribed by law and upon payment of a license fee, license any premises as a Licensed Bonded Warehouse for the deposit of goods subject to Customs control. The license shall be in Form C23. Customs warehouses and warehouses owned by the Government shall not be subject to any license fee.

(iii) The operator of a Licensed Bonded Warehouse shall execute a bond security in Form CB6 secured by a licensed guarantor. A bond security of not less than TShs.300 million shall apply to Private Warehouses and Shs.800 million to General Warehouses to secure duties and taxes on the goods kept at the Warehouse.

(iv) Customs shall at all times have the right of access to any part of a Licensed Bonded Warehouse and may examine any goods or records relating to goods therein; and for the purpose of obtaining such access, a proper officer may break open the warehouse or any part thereof.

(v) The operator of a Licensed Bonded Warehouse shall keep the warehouse in a proper state or repair and shall not make any alteration or addition to the warehouse without first obtaining the written permission of the Commissioner.

(vi) Licensed warehouse operators are required to maintain control of the warehouse, warehoused goods and any activity undertaken in the warehouse. The Commissioner for Customs and Excise must be notified in the event of any change in the circumstances of the operator, which may render the operator unable to honor the warehouse bond or acquit its responsibilities to Customs. Circumstances include a change in the ownership of the warehouse, the death of the operator, the commencement of proceedings of bankruptcy against the operator or any other change in the circumstances of the operator. Warehouse licenses are not transferable.

(vii) The operator of a Licensed Bonded Warehouse is responsible for all goods stored in the warehouse and is liable for the payment of all duties and taxes payable on any goods that cannot be accounted for. It is a requirement that the records maintained for Customs purposes shall provide a clear audit trail of all goods that arrive, are stored and/or exit the warehouse.

(viii) No goods stored in the warehouse shall be removed, altered, interfered with, displayed or demonstrated in any way without prior authorisation from Customs.

(ix) A license holder who contravenes any of these conditions may have their license revoked.

(x) Specific Conditions s. 64

a. Warehouse Premises

The Licensed Bonded Warehouse shall:

- ✓ Comprise premises with secure walls, roof(s) and concrete floors
- ✓ Include special storage facilities for high value items, loose cargo and seized, abandoned or overstayed goods (not applicable to motor vehicle ICDs).
- ✓ Have a floor area equal to or greater than 1000 square metres for a general warehouse and 350 square metres for a private/factory bonded warehouse.
- ✓ Have a single entrance, acceptable lighting and toilets and be hygienic and well ventilated.
- ✓ Be secure, accessible and located in a safe environment not more than 10 km from a customs office or at a location approved by the Commissioner for Customs and Excise.

b. Warehouse Identification

- ✓ The words "Customs Bonded Warehouse" and the number allocated to the customs bonded warehouse shall be clearly marked above the principal entrance to the customs warehouse or elsewhere as approved by the proper officer and shall be removed when a warehouse ceases to be so licensed.

c. Security

- ✓ **Security arrangements shall provide for:**
- ✓ A perimeter wall or secure fence that is at least three meters high with razor wire and lockable gates;
- ✓ 24 hours security coverage; and
- ✓ Satisfy any other requirements determined by the Collector of Customs and Excise

d. Customs Facilities

- ✓ Secure office accommodation shall be provided within the premises for the exclusive use of customs staff required to attend the warehouse. The accommodation should include suitable furnishings, desk(s) and chair(s) and be hygienic and well ventilated with adequate lighting. Access shall also be provided to warehouse records, a telephone and appropriate toilet facilities. Details of the facilities should be shown on the premises plan.

e. Handling and Examination Equipment

- ✓ **The Licensed Bonded Warehouse operator shall provide:**
- ✓ Appropriate handling, stacking and examination facilities and equipment including, but not limited to, scales, measures, lifting and packing/unpacking equipment etc.
- ✓ Sufficient staff to operate the equipment and to pack and/or unpack goods.

f. Permitted Goods and Operations

- ✓ An applicant for a licensed bonded warehouse shall nominate the type of the goods to be warehoused and the operations that are to be performed in the warehouse. The Commissioner for Customs and Excise will decide what types of goods and/or the extent of operations that will be permitted in the warehouse. A Licensed Bonded Warehouse operator shall not store goods or perform operations outside of those permitted by the Commissioner.

g. Communications and Computer Connectivity

- ✓ The Bonded Warehouse must have a computer and line connection to the Automated Systems for Customs Data (ASYCUDA ++) for the purposes of accounting for warehoused goods, preparing and registering warehousing declarations and for performing other functions via the system. For the computer to be compatible with ASYCUDA++, It must be at least a Pentium 4, Windows XP (Professional), 512 RAM, 30 MB disk space, external CD-ROM with a processor speed of at least 1.7 MHz.
- ✓ The operator of a Licensed Bonded Warehouse shall have and maintain appropriate communication facilities including telephones, a facsimile machine and access to e-mail.

h. Accounting and Record Keeping Requirements

- ✓ The operator of the bonded warehouse must be able to fully account for all present and previous warehoused consignments. The operator shall:
- ✓ Submit to customs a return of goods remaining the bonded warehouse at the close of business on 30th June each year and not later than the 31st July, of the same year.
- ✓ Maintain and retain, for a period of five years, records and details related to all goods that arrive, are stored and/or exit the warehouse. Records must be in a form approved by customs.
- ✓ An applicant for a licensed bonded warehouse shall provide full details of accounting and record keeping arrangements and systems proposed to be used at the warehouse. Customs will evaluate such arrangements and systems and if necessary indicate changes/improvements that need to be made. Once accounting and record keeping arrangements and systems are approved by Customs, they shall be operated in accordance with the approval. Prior notification of any proposed changes to arrangements or systems must be given to customs before they can be implemented.

i. Compliance and Understanding of Warehouse Requirements

An applicant for a Licensed Bonded Warehouse license and all persons who shall participate in the management or control of the warehouse shall have an acceptable compliance record to the extent that they shall have complied with all Customs procedures and the laws of Tanzania.

Applicants and persons that participate in the management or control the warehouse shall possess a knowledge of Customs requirements relating to the operation of a licensed warehouse and the control of under-bond goods, including a sound understanding of Customs requirements and procedures in relation to import entries, warehousing entries, export entries, and under-bond movements.

Test yourself 1

Warehousing is the practice of storing, holding and handling goods in a warehouse. A customs bonded warehouse is a warehouse licensed by the Commissioner of Customs for the storage of goods imported into the region pending the payment of duties. The goods are stored in the joint custody of the bonded warehouse keeper and customs.

Required:

(a) What are the benefits of using a Customs Bonded Warehouse?
(b) How many types of bonded warehouses are there? Describe them.
(c) What is the licensing procedure?
(d) Is the bonded warehouse license transferable? Explain
(e) What records should be kept at the bonded warehouse?

Customs Warehouse"

Means any place approved by the Commissioner for the deposit of unentered, unexamined, abandoned, detained, or seized, goods for the security thereof or of the duties due thereon;

CUSTOMS WAREHOUSE DATE:

(i) Normally customs warehousing date is the 21st day (excluding Sundays and public holidays after the commencement of discharging goods from the importing vessel or aircraft and in the case of importation by land it is the 21st day after the arrival of the goods at the frontier station.
(ii) The un entered and un claimed goods are sent to the customs warehouse vide WANT OF ENTRY LIST prepared by port authorities (T.H.A. TICTS, DAHACO etc.). Other goods are sent to the customs warehouse vide their respective documents e.g. Notice of seizure – C.58, goods deposited – by F. 89 etc.

SALES PROCEDURES FOR WAREHOUSED GOODS AND CONDITIONS FOR AUCTION SALE (SEC. 42)

(i) Normally goods deposited in a customs warehouse must be delivered or removed within 30 days from the day of entry subject to order from the Commissioner to extend the period of stay.
(ii) Goods that are not lawfully removed from the customs warehouse within a specified period, shall be deemed to have been abandoned and hence be sold by public auction or in any manner as the Commissioner may direct.
(iii) The Commissioner shall give 30 days notice by publication in the Gazette to the public stating his or her intention to the deposited goods after the expiry of such period from the of the notice if goods shall not be lawfully remove.
(iv) Prohibited goods shall either be re-exported or destroyed depending on the Commissioner's decision.
(v) Perishable goods, Plants or Animals may be sold without any notice.
(vi) Seized goods will be sold after clearance from the Commissioner on accountthat such goods might be under appeal or court proceedings.
(vii) Reserve price
(viii) This is a minimum disposable price that includes customs duty and taxes and other charges due to the Commissioner and Port Authorities Reserve price is confidential to the department and no way should it be disclosed to the public. During auction sale a bid must be equal or higher than the reseve price. Goods are normally sold in lots as indicated in bill of landing or individual depost or sezure notice, so when a bid is lower than the reserve price thenthe whole lot shall be wiedrawn from sale.

CONDITIONS FOR AUCTION SALE:

(i) Before bidding the Commissioner announces to the public that a bid shall not necessarily be accepted and should there be any discrepancy between the quantity stated in the sale list and the actual quantity available for sale.
(ii) Making a bid shall imply acceptance of the conditions of sale.

(iii) The highest bidder shall be the purchaser of the goods and shall be no withdrawal when accepted as a purchaser.
(iv) No warranty shall be given by the Customs as to the quality, quantity, packaging conditions and any other particulars of the goods offered fore sale.
(v) A non refundable deposit as determined by the Commissioner shall be paid in cash at the fall of the hammer and the balance shall be paid within forty eight (48) hours after the sale, failure to that, the goods shall be re-offered for sale at the next auction sale.
(vi) Goods purchased shall be removed from the customs warehouse within three (3) days, failing of which the purchaser shall be liable to pay the warehouse rent and other charges with effect from the date of sale up to the date of removal.
(vii) The Customs shall not be responsible for any damage that occurs to goods during their removal by the purchaser or his/her Agent.
(viii) Any goods remaining in the customs warehouse after sale, shall remain at the purchaser's risk.

APPLICATION OF SALE PROCEEDS.

(i) The discharge of duty and taxes.
(ii) The discharge of sales and handling expenses.
(iii) The discharge of warehouse rent and other charges due to customs.
(iv) The discharge of the Port charges.
(v) The discharge of the freight and other charges if any.
(vi) Net balance if any shall be paid to the owner of goods only if he/she does not have any tax liability to the government. He/She should lodge an application for payment of the balance in a prescribed form within twelve months from the date of sale. Failure to that the balance shall be paid into customs revenue.

DELIVERY OF GOODS FROM CUSTOMS WAREHOUSE

(i) By virtue of section 33(4) of EACCMA, 2004 goods shall not be removed from a customs warehouse unless such goods have been duly reported and entered. The proper officer must also have given the authority for their delivery.

(ii) For dutiable goods, which were warehoused protect the loss of government revenue, shall be delivered from the customs warehouse upon presentation of customs entry showing a payment of all customs duty taxes. For Seized and Detained goods, shall be delivered from the customs warehouse upon presentation of the order written by the Commissioner.

Customs warehouse rent.

Rent shall be charged on goods deposited, or deemed to be deposited, in a Customs warehouse at the rates determined by the Commissioner. Rent shall not be charged on passenger baggage where the baggage is removed within seven working days from the date of deposit in a Customs warehouse. The Commissioner may waive the whole or any part of the rent charges. All rents and charges on goods deposited, or deemed to be deposited in a Customs warehouse shall be paid before the delivery of the goods.

Customs premises deemed to be Customs warehouses.

Where at any port or place in the Community where a proper officer is stationed, a building has not been specifically approved by the Commissioner for use as a Customs warehouse, any customs remises or any premises occupied and administered by the Customs shall be deemed to be a Customs warehouse.

6. Differentiate Between Prohibited And Restricted Goods

Governments have the duty and responsibility to protect the society and economy of their respective countries. The Customs, as government service has the duty to protect the society and the economy of the country by *allowing, prohibiting and restricting* goods that enter in the country. This is for the sake of *maintaining security, healthy society and sound economy.*

Definitions
Cargo
Includes all goods imported or exported in any aircraft, vehicle or vessel other than such goods as required as stores for consumption or use by or for the aircraft, vehicle or vessel, its crew and passengers.
Goods
Includes all kinds of articles, wares, merchandise, livestock, and currency, and, where any such goods are sold under the, the customs laws, and the proceeds of such sale

Prohibited goods
Prohibited goods are goods, which importation exportation or carriage coastwise are not allowed under the East African Community Customs Management Act 2004 or any law for the time being in force in the Partner States;

Restricted means
Restricted goods means any goods the importation, exportation or carriage coastwise of which is prohibited, save in accordance with any conditions regulating such importation, exportation, transfer, or carriage coastwise, and any goods the importation, exportation, transfer, or carriage coastwise, of which is in any way regulated by or under the Customs laws or is allowed subject to certain conditions.
Customs area
Means any place appointed by the Commissioner under section 12 for
carrying out customs operations, including a place designated for the deposit of goods
subject to customs control;

Controls Under The Kyoto Convention

All goods, including means of transport, which enter or leave the Customs territory, regardless of whether they are liable to duties and taxes, shall be subject to Customs control.
The Customs control shall be limited and applied when necessary to ensure compliance with the Customs law.
In the application of Customs control, the Customs shall use risk management.
The Customs shall use risk analysis to determine which persons and which goods, including means of transport, should be examined and the extent of the examination.

The Customs shall adopt a compliance measurement strategy to support risk management.
Customs control systems shall include audit-based controls.
The Customs shall seek to co-operate with other Customs administrations and seek to conclude mutual administrative assistance agreements to enhance Customs control.
The Customs shall seek to co-operate with the trade and seek to conclude Memoranda of Understanding to enhance Customs control.
The Customs shall use information technology and electronic commerce to the greatest possible extent to enhance Customs control.
The Customs shall evaluate traders' commercial systems where those systems have an impact on Customs operations to ensure compliance with Customs requirements
The concept of prohibitions and restrictions is also embedded in the **WCO Mission Statement.**
"The World Customs Organization is an independent intergovernmental body whose mission is to enhance the efficiency and effectiveness of Member Customs administrations, thereby assisting them to contribute successfully to national development goals, particularly in the areas of trade facilitation, revenue collection, ***community protection*** *and national security."*

CONTROLS UNDER THE EAST AFRICAN COMMUNITY
Category of goods subject to Customs controls are in Sec 16(a) of The East African Community Customs Management Act, 2004
The following goods shall be subject to Customs control.

(a) Imported goods, including goods imported through the Post Office, from the time of importation until delivery for home consumption or until exportation, whichever first happens;
(b) Goods under duty drawback from the time of the claim for duty drawback until exportation;
(c) Goods subject to any export duty from the time when the goods are brought to any port or place for exportation until exportation;
(d) Goods subject to any restriction on exportation from the time th goods are brought to any port or place for exportation until exportation;
(e) Goods which are with the permission of the proper officer stored I Customs area pending exportation;
(f) Goods on board any aircraft or vessel whilst within any part or place in a Partner State;
(g) Imported goods subject to duty where there is a change of ownership over such goods from an exempt person to a non-exempt person;
(h) Goods which have been declared for or are intended for transfer to another Partner State;
(i) Seized goods.

Where any goods are subject to Customs control, then the Commissioner may permit the owner of such goods to abandon them to the Customs; and on such abandonment such goods may, at the expense of the owner thereof, be destroyed or otherwise disposed of in such manner as the Commissioner may direct and the duty thereon shall be remitted or refunded**,**

Regional Law on Prohibitions and Restrictions, EACCMA, 2004
Legal authority
Legal authority governing prohibitions and restriction is specifically set out in Section 18, 19 and 20 EACCM Act, 2004.

Powers to prohibit or restrict, Sec. 19 EACCM Act, 2004.

i. The Council has the power to prohibit or restrict goods, by order published in the Gazette.
ii. The Council may, by order published in the Gazette, prohibit or restrict certain goods under

EACCMA, 2004 or any law for the time being in force in the Partner States.

iii. Order made under section 19 may specify goods or any class of goods, either generally or in any particular manner and may prohibit or restrict the importation either from all places or from any particular country or place.

Exemptions

Goods imported in Transit, Transshipment or as stores of any aircraft or vessel are exempted from restriction and prohibitions provided that such goods are not internationally prohibited or restricted and such goods should be dully re-exported within such time as the Commissioner may specify. **(Section 20 EACCMA, 2004)**

5 Prohibited Goods

Any goods the importation, exportation or carriage coastwise, of which is prohibited under the EACCMA, 2004 or any customs law for the time being in force in the Partner States.

- **Part A of the second schedule** list shows the goods whose importation is prohibited. These include
- False money,
- Pornographic materials,
- Matches- with white phosphorus,
- Distilled beverages- injurious oils or chemicals,
- *Narcotic drugs under international control,*
- Hazardous wastes,
- Soaps and cosmetics-mercury,
- Used tyres-commercial m/v and passengers cars.

Also the list covers both hazardous agricultural and industrial chemicals and the counterfeit goods of all kind.

6 Restricted Goods

Any goods the importation, exportation or carriage coastwise of which is prohibited, save in accordance with any conditions regulating such importation, exportation, transfer, or carriage coastwise, and any goods the importation, exportation, transfer, or carriage coastwise, of which is in any way regulated by or under the Customs laws or is allowed subject to certain conditions.

Part B of the second schedule covers the restricted goods whose importation is upon meeting the regulating conditions, unless they are prohibited.

Restricted goods list cover the following:

- Postal frank machines,
- Traps-for game animals,
- Unwrought precious metals,
- Arms and ammunition (chap93),
- Ossein and bones-treated with acid,
- Ivory (elephant) unworked,
- Hippo teeth (unworked),
- Ivory powder and waste,
- Tortoise shell,
- Coral and similar materials,
- Nuclear reactors,
- Natural sponges of animal origin,
- Worked ivory and articles of ivory,

- Ozone depleting substances (Montreal Protocol 1987) & Vienna Convention (1985), genetically modified products,
- Endangered Species of world Flora and Fauna-CITES 1973
- Commercial casings (second hand tyres),
- All psychotropic drugs under international control.

Others include goods under chap 36 (i.e. detonators), guns and ammunition, armoured fighting vehicles-heading 8710, telescope sights-chap 90, bows, arrows, fencing foils-chap95, collectors pieces/antiques of guns-heading 9706.

Note: Goods may be prohibited or restricted under this law or any other law for the time, being enforced in the Partner State.

Under EACCMA, 2004 the provisions on prohibited and restricted exports include Section 70, 71, and 72 of EACCMA, 2004 on which under the third schedule a lists prohibited and restricted exports :

Part A; All goods the exportation of which is prohibited under EACCMA.

Part B;

(i.) All goods the exportation of which is restricted under the Act

(ii.) Waste and scrap of ferrous cast iron

(iii.) Timber from any wood grown in partner states

(iv.) Fresh unprocessed fish (Nile Perch and Tilapia)

(v.) Wood charcoal

The following should not be exported in vessels of less than 250 tons register

(i.) Warehoused goods;

(ii.) Goods under duty drawback;

(iii.) Transhipped goods.

Reasons for imposition of Prohibitions or Restrictions

(i) Political Reasons:

Importation of seditious publications that may entice the public to revolt from a lawful elected government, are prohibited. Upon importation, such publications should be seized and an offence instituted against the offender.

(ii) Economic Reasons

- Importation of false money and counterfeit currency notes and coins is prohibited.
- Certain imported manufactured goods that may have material injury (harm) to local industries in Partner States, such importation are restricted.

(iii) Social Reasons

Importation of pornographic materials in all kinds of media, indecent or obscene prints, books, cards, lithographs and other materials of similar nature are prohibited.

(iv) Security Reasons

Importations of lethal weapons, silencers, firearms, and flick knives are prohibited. Arms and ammunition other than military are restricted save by fulfilling the conditions of restriction such as, obtaining import license from the police.

(v) Health Reasons

- Importation of dangerous drugs, such as drugs of abuse is prohibited unless imported by a specializing institution i.e. hospitals, laboratories and health centers under the approval of Ministry of Health.
- Importation of second hand clothing is restricted unless they have been fumigated and approved by Health authorities.
- Importation of foodstuffs is restricted unless the Health officers have approved the importation.

(vi) Agricultural Reasons

The importation of plants, seedlings, seeds for sowing and game animals are restricted. The importations of such goods save in accordance with any conditions regulating their importation.

(vii) International Conventions on Prohibited and Restricted Goods

- International Convention on Drugs of Abuse
- The Single Convention on Narcotic Drugs, 1961
- The convention on Psychotropic Substances, 1971
- The United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, 1988
- Convention on International Trade in Endangered Species (CITES)

The regulating authorities and agencies working in conjunction with Customs.

The customs administration in Tanzania works in conjunction with other regulating authorities and agencies to effect importation, exportation, transit and other customs procedures. The customs procedure might not be complete until the regulating authority for such goods has been satisfied and made certification. Scientific opinion regarding importation from such authorities is paramount for revenue side, economic growth, public morality, security and safety of society and plants and animals' health.

Mainland Tanzania

i Tanzania Bureau of Standards (TBS)- overseeing the standards requirement of imports
ii Atomic Energy Commission-
iii Health Department(Ministry of Health)- regulating requirement on human medicine and certification
iv TFDA (Tanzania Food and Drugs Authority)- regulate the importation and exportation of foods and drugs
v Police, (Interpol) and Intelligence Unit
vi Fair Trade Commission (FTC)
vii TCCIA-Chambers of Commerce
viii Money Laundering Commission
ix NEMC- National Environmental Management Commission
x Immigration Department
xi Embassies, NGOs and Business Community
xii Drug Regulatory Authority
xiii Tanzania Investment Centre (TIC) for assessing and certification of potential investors
xiv Ministry of Industries and Trade (BRELA),

Zanzibar

i ZIPA (Zanzibar Investment promotion Agency)
ii Police-Interpol on matters related to security, theft of imported vehicles
iii Anti –Narcotic Unit
iv Zanzibar Medical Board on food and drugs imports
v Immigration Department on further inquiry of drug trafficking suspects.
vi Consumer Protection Unit (Ministry of Tourism, Investment and Trade)
vii Veterinary Department (Ministry of Agriculture and Livestock)
viii Health Department (Ministry of Health)

International Conventions on Prohibited and Restricted Goods

6.1 International Convention on Drugs of Abuse

The control of narcotic drugs has been of global concern ever since the first international conference on the subject, which was held in Shangai in 1909.
The international control system has been built up step by step, continuing from 1920 under the auspices of the League of Nations, and since 1946 by the United Nations.
A series of treaties adopted under the auspices of the UN require that:

- Governments should exercise control over production and distribution of narcotic drugs and psychotropic substances.
- Governments should combat drug abuse and illicit traffic.
- Governments should maintain the necessary administrative machinery and report to international organs on their actions.

The Single Convention on Narcotic Drugs, 1961

This convention had 177 members as at 1st July 2005. This convention replaced the treaties concluded before the Second World War on **opiates, cannabis and cocaine.**
At present, control is exercised over more than 116 narcotic drugs, including opium and its derivatives as well as synthetic narcotics such as **methadone and pethidine.**

The convention on Psychotropic Substances, 1971

This convention had 176 states/parties as at 1st June 2005. It controls drugs not covered by previous treaties. These include **hallucinogens, amphetamines, barbiturates, non-barbiturates sedatives and tranquillizers**.
About 105 psychotropic substances are controlled, most of them in pharmaceutical products acting on the central nervous system.
These calls for substances:

- Those have been judged to be particularly dangerous, such as LSD, to be placed under even stricter control than narcotic drugs.
- With wide legitimate medical use to be controlled in a less stringent way not to hamper their availability for medical purposes but on the other hand to avoid their diversion and abuse.

The United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, 1988

This has about 172 States/parties as of 1st June 2005.

- Prevents money laundering obtained from illicit trafficking.
- Provides concrete instruments for international law enforcement co-operation.
- Provisions covering tracing, freezing and confiscation of proceeds and property from drug trafficking.
- Courts are empowered to make available or to seize bank, financial or commercial records, but bank secrecy cannot be invoked.
- Mutual legal assistance between states on drug-related investigations, controlled deliveries, transfer of proceeding for criminal prosecution.
- Extradition of drug traffickers.

Convention on International Trade in Endangered Species (CITES)

The Convention of International Trade in Endangered Species of Wild Fauna and Flora was signed on March 3, 1973 in Washington, USA and amended in Bonn, on 22 June 1979. It came into effect on July 1, 1975.166 member states (Parties)

The aim of CITES *is to ensure that international trade in wild fauna and flora does not threaten the survival of these species.*

Misconceptions about CITES

But most of the people have misconceptions about CITES as follows:

i CITES bans trade in the species listed.

ii CITES regulates the domestic use of species and their trade.

iii CITES focuses on species of well-known large fauna (elephants, rhinoceroses)

iv CITES is the conservation of wild flora and fauna.

Contracting States (Parties) of CITES agree upon the following;

i. Wild fauna and flora in their beauty and varied forms are an irreplaceable part of the natural systems of the earth that must be protected generations to come.
ii. People and States should get involved in protection of their own wild fauna and flora.
iii. The international co-operation is essential for protection of certain species of wild fauna and flora against over-exploitation through international trade.
iv. The urgency of taking appropriate measures to end over-exploitation of certain species of wild fauna and flora.
v. The importation or exportation of goods covered under the CITES is restricted.

Trade Related Aspects for Intellectual Property Rights (TRIPS)

The WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), negotiated in the 1986-94 Uruguay Round, introduced intellectual property rules into the multilateral trading system for the first time.

Types of intellectual property

The areas covered by the TRIPS Agreement

- Copyright and related rights
- Trademarks, including service marks
- Geographical indications
- Industrial designs
- Patents
- Layout-designs (topographies) of integrated circuits
- Undisclosed information, including trade secrets

OZONE DEPLETING SUBSTANCES (ODS)

Science of Ozone Layer

What is Ozone?

Ozone is a gas composed of three Oxygen atoms (O3). The regular Oxygen molecules (O2) contained in the ambient air consists of only two atoms of Oxygen. Ozone molecules are created by a photochemical reaction; when oxygen (O2) in the Stratosphere is broken into two highly reactive Oxygen atoms (O + O) by absorbing the Ultraviolet light energy (UV-light) from the Sun. These reactive Oxygen atoms react with Oxygen molecules (O2) to form Ozone molecule (O3).

(UV light + O   O + O).(2O + 2O   2O)

3O   2O + 2O. 2O

• What is Ozone Layer?

The Ozone layer is a term used to describe the presence of Ozone molecules in the stratosphere or a band of Ozone-rich air (containing Ozone molecules) found at an altitude ranging from 10 – 50 kilometres above the earth.

- The Stratosphere

The stratosphere is that part of atmosphere, which follows the troposphere. It starts at 10-20 kilometres above ground level and continues up to 40-50 kilometres height.

- What is Ozone Depleting Substance (ODS)?

It is a chemical substance that has the potential to react with Ozone molecules in the Stratosphere. They are basically chlorinated, fluorinated or brominated hydrocarbons and include:

(i) Chlorofluorocarbons (CFCs)
(ii) Hydro chlorofluorocarbons (HCFCs)
(iii) Halons
(iv) Hydrobromofluorocarbons (HBFCs)
(v) Bromochloromethane
(vi) Methyl chloroform
(vii) Carbon tetrachloride and;
(viii) Methyl bromide.

The ability of these chemicals to deplete the Ozone Layer is referred to as Ozone Depleting Potential (ODP).Each substance is assigned an ODP relative to CFC-11 whose ODP is defined as one.

Basel Convention on the Control of Trans-boundary Movements of Hazardous Wastes and Their Disposal;

The Convention strictly regulates the trans-boundary movements of hazardous wastes and provides obligations to its Parties to ensure that such wastes are managed and disposed of in an environmentally sound manner.

The Rotterdam Convention on the Prior Informed Consent (PIC) Procedure for Certain Hazardous Chemicals and Pesticides in International Trade.

It controls both banned or severely restricted chemicals and severely hazardous pesticide formulations.

Stockholm Convention on Persistent Organic Pollutants

Kyoto Protocol on control of greenhouse gas emissions

It sets binding limits on for developed countries and creating significant incentives for developing countries to control their greenhouse gas emissions.

7. Rules Of Origin In The East Africa Customs Union

Rules of Origin are the laws, regulations and administrative procedures which determine a product's country of origin. The Protocol provides that trade within the EAC will be conducted in accordance with agreed East African Rules of Origin.

7.1 Criteria for Determination of Origin

Goods shall be accepted as originating in a Partner State where they are consigned directly from a Partner State to a consignee in another Partner State and where:

(i) they have been wholly produced or obtained in a Partner State

(ii) they have been produced in a Partner State wholly or partially from materials imported from outside the Partner State or of undetermined origin by a process of production which effects a substantial transformation of those materials such that the c.i.f. value of those materials does not exceed sixty per centum of the total cost of the materials used in the production of the goods

(iii) the value added resulting from the process of production accounts for at least thirty five per centum of the ex-factory cost of the goods.

(iv) the goods are classified or become classifiable under a tariff heading other than the tariff heading under which they were imported as specified in the Second Schedule to these Rules.;

Principles relating to Rules of Origin

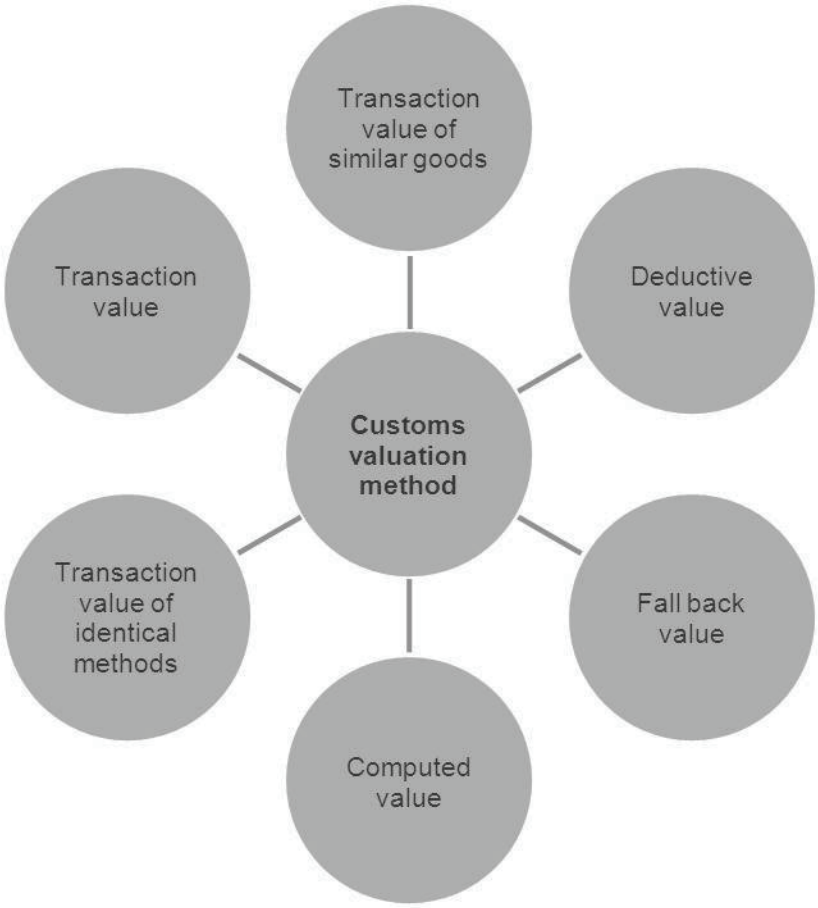
(i) Cumulative Treatment Principles
For the purpose of implementing these rules, the partner state shall be considered as one territory. Raw materials or semi-finished goods originating in any of the Partner States and undergoing working or processing either in one or more Partner State shall, for the purpose of determining the origin of the finished product be deemed to have originated in the Partner State where the final processing or manufacturing takes place.

(ii) Principle of Asymmetry
Principal of asymmetry" means the principle which addresses variances in the implementation measures in an economic integrations process for purposes of achieving a common objective; that is an unequal treatment among trading partners to achieve certain purpose in a specific period of time.

8. Customs Valuation Methods

There are six methods which can be used to compute custom value of imported goods. The customs value of imported goods is the value of goods for the purposes of levying ad valorem duties of customs on imported goods. These methods are transaction value, transaction value of identical goods, transaction value of similar goods, deductive value, computed value and fall back value. The methods are sequential used starting the first method, when it fails or not trusted, the second method is adopted also when the second method is not appropriate, the third method is adopted and so on. With the exception of deductive and computed value methods where the importer can ask for reverse of the order (Paragraph 9(3)). The following Section describes each of these methods.

Diagram 1: Customs valuation method



8.1 Transaction value

Transaction value refers to actual price of the goods imported between independent buyers and sellers. The transaction value is taken to be custom value of imported goods when the buyer is free to choose how to use or sell the goods subject to legally imposed restrictions and the price is not significantly affected by the sellers' restrictions. Furthermore, the price should include all values attached to it by the sellers and the sellers should not receive anything from subsequent re-sale of the goods. Additionally, all costs paid by importer/buyer for the goods should be included (or apportioned when not wholly used in the goods) in the transactions value with exception to buying commission. The buying commission means fees paid by importer to the importer's agent for the service of representing the importer abroad in the purchase of the goods being valued. Finally, cost of transport of the imported goods to the port or place of importation into the importing country except where the importation is made by air; loading, unloading and handling charges associated with the transport of the imported goods to the port or place of importation into the importing country; and the cost of insurance are part of **customs value of imported** goods.

Moreover, the price should be free from buyers and sellers relationship even if the parties are related.

However, when the parties to the imported goods are related, the importer should show that the transaction value is approximate to the price of identical or similar goods imported around the same time between unrelated parties.

The importer also might require comparing the transaction value to the transaction value of identical goods or similar goods as explained below when the importer and exporter are related.

The importer and exporter are related when they are officers or directors of one another's businesses, legally recognised partners in business, an employer and employee relationship, any person directly or indirectly owns, controls or holds 5% or more of the outstanding voting stock or shares of both of them, one of them directly or indirectly controls the other, both of them are directly or indirectly controlled by a third person, together they directly control a third person or are members of the same family. However, sole agents, distributors and sole concessionaires dealing with others are normally considered independent unless they have previously discussed conditions.

Question 2

1. Mr Ndikumana imported electrical appliances from England for STG 340,000 and paid for insurance and freight of STG 17,000 and STG 45,000 respectively. Mr Ndikumana also incurred the following expenses in respect of the electrical appliance:

	STG
Brokerage charges	1,200
Selling Commissions	300
Buying Commissions	400
Royalty	200
Wooden containers used for packing in England	500
Packing expenses in England	120
Tools and moulds	2,000

Mr Ndikumana shall, after one month from the date of exportation, pay to the exporter STG 120,000 being the difference between the invoice value and the price of goods; fact revealed to Customs officers by Ndikumana

Required:

Determine the Customs value according to Transaction value method

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8.2 Transaction value of identical goods

The transaction value of identical goods is used as an alternative when the transaction value of imported goods is inappropriate. However, transaction value of identical goods and the goods being valued should all have been imported at the same time, same commercial level.

In case of the transaction value of identical goods at the same commercial level and/or same quantity is unavailable best adjustments should be made to adjust for factors as discount resulting from purchasing in large quantities. Specifically, the transaction value of identical goods in this case may base on, a sale at the same commercial level but in different quantities; a sale at a different commercial level but in substantially the same quantities; or a sale at a different commercial level and in different quantities. Thereafter, the adjustments for quantity factors only, commercial level factors only or both commercial level and quantity factors as case may be made.

Also, when the transaction value of identical goods includes costs of; transport of the imported goods to the port or place of importation into the importing country except where the importation is made by air; loading, unloading and handling charges associated with the transport of the imported goods to the port or place of importation into the importing country; and the cost of insurance, the value should be adjusted to consider cost differences as distances and transport modes of the imported goods. Finally, in case of identification of several transaction values of identical goods, the lowest value should be used to value the imported goods.

Definition

Goods are identical when they have the same physical characteristics, quality and reputation even when they have minor differences between them. Furthermore, the goods must have been produce in the same country by the same person unless the goods produced by the same person are unavailable others' goods can be used. The identical goods do not include goods which incorporate or reflect engineering, development, artwork, design work, and plans and sketches for which no adjustment of the values can be made.

8.3 Transaction value of similar goods

Where the two first methods are unacceptable, the customs value of imported goods might be measured using the transaction value of similar goods. In fact, the applicability of the transaction value of similar goods is exactly the same as the application of transaction value of identical goods, they differ only on "similar goods" for the former and "identical goods" for the latter.

Definition

Goods are similar when although not alike in all respects; have like characteristics and like component
materials which enable them to perform the same functions and to be commercially interchangeable. Factors as the quality of the goods, their reputation and the existence of a trademark may help in determining similarity of goods. Furthermore, the goods must have been produce in the same country by the same person unless the goods produced by the same person are unavailable others' goods can be used. The similar goods do not include goods which incorporate or reflect engineering, development, artwork, design work, and plans and sketches for which no adjustment of the values can be made.

Question 3

Ndala imported an item from Japan. On the arrival of the item, Ndala could not produce valid documents acceptable by the Customs Department. For that case, Customs Officers came out with the following values for such imported item:

Values for identical items:

- A – Tshs.40 million
- B – Tshs.50 million
- C – Tshs.45 million

Values for similar items:

- D – Tshs.30 million
- E – Tshs.35 million

F – Tshs.60 million

Required:

Determine the Customs value of the item imported

8.4 Deductive value

Where the previous methods are not sufficient in valuing the imported goods, the deductive value may be appropriate. Under this method the value of the imported goods should be the unit price at which the imported goods or identical or similar imported goods are sold in the greatest aggregate quantity, at or about the time of the importation of the goods being valued or the earliest date within 90 days after the importation of the imported goods; between independent persons in the importing country. However, after deductions of the following items:

(a) Commissions, mark-ups or any expenses charged in the importing country;
(b) Transportation expenses, insurance and associated costs incurred within the importing country;
(c) Cost of transport of the imported goods to the port or place of importation into the importing country; loading, unloading and handling charges associated with the transport of the imported goods to the port or place of importation into the importing country; and the cost of insurance; and

(d) The customs duties and other national taxes payable in the importing country by reason of importation or sale of the goods

However, when the imported goods, identical or similar imported are sold in the importing country after further process, the importer may requests the Commissioner to value the imported goods based on the unit price at which the imported goods, after further processing, are sold in the greatest aggregate quantity between independents persons in the importing country after deduction of the value added by such processing and the deductions items discussed before.

Example

Consider the following price list of goods sold in an importing country after including Tshs3 covering profit, Commissioner, transport and customs taxes:

Units sold	Price per unit
20	Tshs10
30	Tshs8
60	Tshs7
100	Tshs5

The greatest number of units sold at a price is 100 so the unit price in the greatest aggregate quantity is 5.

Question 4

XYZ Ltd imported used items from America which do not qualify for Transaction value or Transaction value of identical or similar goods. The importer provides you with the following information:

- The general expenses and profit of the importer averaged to Tshs 500,000 per item sold.
- The importer paid Tshs 250,000 per item to label it in Tanzania.
- The total duties and taxes on items from America is 25%
- They are sold to retailers as follows

Items sold	Price per item
20	Tshs10,000,000
30	Tshs8,000,000
60	Tshs7,000,000
100	Tshs5,000,000

Required:
Calculate the Customs value using deductive method per piece.

8.5 Computed value

The next method is computed value. The computed value method determine the value of imported goods based on its cost of productions in the exporting country and costs of transportation, insurance and handling to the importing country. Specifically, the costs of imported goods under computed value method is the total of:

(a) the cost or value of materials and fabrication or other processing employed in producing the imported goods;

(b) an amount for profit and general expenses equal to that usually reflected in sales of goods of the same class or kind as the goods being valued which are made by producers in the country of exportation for export to the importing country;

(c) The cost of transport of the imported goods to the port or place of importation into the importing country except where the importation is made by air; loading, unloading and handling charges associated with the transport of the imported goods to the port or place of importation into the importing country; and the cost of insurance.

Subsequently, access to accounting records based on GAAPs is important in applying this method, which can be done through requiring a producer or any person especially when is not resident in the importing country to produce such access. Also, a tax authority can verify the information produced by manufacturer in another country after an agreement with the producer and the allow such an investigation.

Question 5

Sumbawanga Ltd has imported a specialized high-speed night travel vessel from the Tuwindane Republic. The information available for the import suggests that only the computed value method can be used.To complete the valuation process, the following information is available:

Production costs	
Direct labour	US \$ 400

Direct materials	US $ 600
Overheads and profit	US $ 320
Freight	US $ 600
Insurance	US $ 200

Required:
Calculate customs value in USD

8.6 Fall back

As the last attempt to value the imported value, a customs authority might use fall back value. This method requires using reasonable means consistent with the principles and general provisions of customs laws and on the basis of data available in the importing country. **It can also base on previously determined customs values or by relaxing conditions of previous methods.** As the method is so judgemental the importer may request written information when this method is used to value the imported goods. Consequently, the fall back value does not base on:

(a) The selling price in the importing country of goods produced in the country;

(b) A system which provides for the acceptance for customs purposes of the higher of two alternative values;

(c) The price of goods on the domestic market of the country of exportation;

(d) The cost of production other than computed values which have been determined for identical or similar goods in accordance with computed value method above;

(e) The price of the goods for export to a country other than importing country; (f) Minimum customs values; or

(f) Arbitrary or fictitious value

Calculate Duties and Taxes collected through customs; explain Customs procedures for prevention of smuggling; determine offences in customs operations; and describe recovery measures used to collect unpaid duties.

[Learning outcome i, j, k, and l]

9. Duties And Taxes Collected Through Customs

The purpose of determining customs value of imported goods is to charge taxes on the imported goods when they are taxable. Customs department charges three main types of taxes on imported goods,

- Import duties,
- Excises duties
- Railway and development levy and
- Value added taxes on imported goods.

These taxes apply on Cascadian ways i.e. first customs import duties is charged on total values of imported goods as discussed above. Then, the value of customs import duties form part of the costs of the goods which is used to determine the excises taxes. Then the total value (including customs import duties) therefore is used to find the excises taxes, then the value excises taxes also is added to the costs of the goods to find the value added taxes. Then railway and development levy is calculated based on CIF/ Customs value. Consequently, the value on which value added tax is based including not only the customs value of imported goods but also the value of customs import, excise duties and railway and development levy.

Definitions

Customs import duties are taxes charged on importation of goods not produced in East Africa Community.

Excises duties are normally, taxes on certain excises goods within the countries, but importing excises goods is also taxable.

The following table presents how customs taxes systems operates

Item	Value	
Customs value of imported	**XXX**	
Import duty (% x ZZZ)	xxx	XXX
Tax base for excise duty(EDB)	**xxx**	
Excise duties (% x EDB)	XXX	XXX
Railway and development levy(%x ZZZ)	xxx	xxx
Tax base for VAT(VB)	**XXX**	
Value added tax (%x VB)	XXX	XXX
Total duties and taxes		xxx

Question 6

Mr. Kwanza imported used Toyota Prado from Japan. The necessary details of the transaction for customs and taxation purposes were as follows:

FOB value	US $ 20,000
Freight Charges	US $ 1,500
Insurance	US $ 100
Import duty	25%
Excise Duty on age	5%
Excise Duty engine capacity	20%
Value Added Tax	18%
Railway and development levy	1.5%

Applicable Exchange rate: Tshs 2,000/US $ 1

Required:

Compute the total import taxes payable by Mr. Kwanza

Question 7

Mention any four possible reasons for imposition of import duty on imported goods.

10. Customs Procedures For Prevention Of Smuggling

Definition

Smuggling is an act of importing, exporting or carrying coastwise, or transferring or removing into or out of a country of goods with intent to defraud the customs revenue or to evade any prohibition or restriction on, regulation or condition as to such importation, exportation, carriage coastwise, transfer, or removal, of any goods.

10.1 Forms of smuggling

- Outright avoidance of official customs controls across the borders: e.g. On Lake Victoria, overland on road, rail and often through the bush ways. This form of smuggling is generally associated with highly marketable goods, goods of high tax value, and prohibited or restricted goods.

- Under declaration of goods: This is a circumstance where the importer declares less quantity on importation documents than the actual goods being imported. This form of smuggling occurs through customs controls – usually deliberately, on the side of the importer.
- Undervaluation of goods: This is a situation whereby goods are given a lower value than they actually have. Undervaluation often happens out of ignorance, negligence or connivance at the customs control. It aids smuggling indirectly.
- Misclassification of goods: This means that goods are declared under a different class of imports particularly to attract lower rates of tax with intent to reduce the tax liability. This again may happen out of ignorance, negligence or deliberately. This problem also aids smuggling.
- Falsification of documents.
- Mis declaration of country of origin.

10.2 Problems associated with smuggling

(i) Loss of revenue: Smuggling is an act of tax evasion which deprives government of revenue for public expenditure.

(ii) Distortion of market prices: Goods which are smuggled into the country are often sold a lot cheaper than goods brought onto market through the right procedures. Smuggling therefore deprives traders of free competition.

(iii) Collapse of local industries: A country achieves better economic growth by developing its own industrial base. Smuggling under-cuts prices of the locally manufactured goods thus destroying the market for local products. This leads to collapse of local industries.

(iv) Unemployment: When there is unfair competition in the market, compounded by the collapsing of industries, the labour market (employment base) is eroded. Many professionals, skilled and unskilled personnel remain jobless.

(v) Loss of lives

(vi) Increased insecurity.

10.3 Power of customs officers to prevent smuggling

Smuggling is not only expensive but also create unfair in tax systems where smugglers pay no taxes. So customs departments they may use following procedures or powers to prevent smuggling and enforce customs tax laws:

(a) Signalling any vessel or aircraft to stop or land for inspection and require the master of the vessel to facilitate the boarding (Section 149).

(b) To require any aircraft or vessel that is not registered in a partner state to leave the partner state within 24 hours (Section 150).

(c) To enter upon and patrol and pass freely along any premises other than a dwelling house or any building. Moreover, they may direct any aircraft, vessel, or vehicle to any place convenient for search and for any time as the officer deem necessary (Section 151).

(d) To board and search any aircraft or vessel within a partner state and may examine, lock-up, seal, mark, or secure, any goods on the aircraft or vessel. Moreover, the proper officer may require goods to be unloaded, or removed, at the expense of the master of such aircraft or vessel. In case access is not given, force may be used to gain the access (section152).

(e) To stop any vehicle or on transit vehicle sought to carry any uncustomed goods, search it or require goods to be unloaded at the expense of the owner of the vehicle. Also force can be used to gain access when necessary (Section 153).

(f) To ask any person entering or leaving a country about his or her luggage or anything carried in it. When the person is leaving or entering the country by a vehicle a proper officer may ask question to the driver or any person in charge of the vehicle about the vehicle, goods in it, and documents related to the vehicle and the goods (Section 154).

(g) To search any person who is suspected of having any uncustomed goods but, a woman officer should search a female suspect and a male suspected must be searched by male officer. If any uncustomed goods found should be forfeited (Section 155).

(h) To arrest with police coordination when necessary any person who is doing, has done, or believed to has done an offence within the last year (Section 156).

(i) To enter and search any building at any time suspected of holding uncustomed goods. Besides, requiring from the owner, or occupier of the building any books, documents or anything which the customs laws require the owner or occupier to keep. And either examine, make copies, seize them, ask questions about them, require container opened, take samples, lock up, seal or secure the building, room, place, tank or container. Uncustomed goods found in the search might be captured and taken away (Section 157

(j) To ask for search warrant from any magistrate to search a building/ premises for uncustomed goods with police officer assistance (Section 158).

(k) To inspect and require immediate production of accounts documents related to suspected smuggling activities or undervaluation of uncustomed goods (Section 159).

11. Offences in Customs Operations

Customs offence is any breach or attempted breach of the statutory or regulatory provisions which are provided in the EAC Customs Management Act (EAC- CMA).

The following is comprehensive list though not exhaustive of offences according to East Africa Customs Management Act 2004 it. Criminalizing these acts help in enforcing customs laws.

1. Engagement in corruption practices, upon conviction the parties involved is subjected to a sentence not exceeding 3 years (Section 9).

2. It an offence to disclose any information obtained during performance of customs duties except in court of law providing witness, a penalty of not more than 2500 dollars or sentence not more than 3 years or both on conviction (Section 9(4)).

3. It is an offence to trespass or leave without following required procedures any customs area or customs airport or bring or take out any goods from the areas. In any contravention, the person, vehicle or goods involved might be detained for investigation also a fine of not more than one 1000 dollars is payable and any goods involved forfeited (Section 15).

4. It is an offence to conspire with others to commit crimes a sentence of not more than 5 years is

imposed after convictions (Section 193).

5. It is a crime to shoot at any aircraft, vessel or vehicle, or an officer on duty and the crime attract imprisonment not exceeding 20 years (Section 195(1)).

6. It is also a crime to act against custom laws or carry any goods liable for forfeiture while armed after conviction a sentence of not more than 10 years may be imposed (Section 195(2)).

7. A person who commits a crime under this Act is disguised any way and while being so disguised, is found with any goods liable for forfeiture under this Act, commits an offence, shall be punishable by imprisonment for a period of not exceeding 3 years.

8. It is a crime committing a crime while disguised or carrying any goods liable for forfeiture while disguised a sentence not exceeding 3 years is imposed after conviction (Section 194(3)).

9. It is an offence to staves, breaks, destroys or throws overboard from any aircraft, vessel or vehicle any goods for the purpose of preventing the seizure or securing of any goods; or rescues any person arrested for any offence; or in any way obstructs.

10. It is an offence illegally removing any customs seal from a ship, an aircraft, vehicle, train or package, and the offender may go to jail for term not exceeding 3 years or pay a fine not exceeding 2500 dollars or to both (Section 195).

11. It is an offence to procure or induces, or authorises another person to procure or induce, any other person to commit or assist in the commission of any offence under customs laws on conviction a sentence not exceeding 1 year may be imposed (Section 196).

12. It is an offence to warn offenders who might have be apprehended without the warning on conviction a sentence not exceeding 2 years or a fine not exceeding 2,500 dollars or both (Section 197).

13. It is an offence to impersonalize a proper officer; on conviction a sentence not exceeding not 3 years is imposed besides other punishments on other offences (Section 198).

14. It is an offence not stopping a vessel or aircraft when required to do so by proper officer upon conviction a penalty not exceeding 2000 dollars and the vessel forfeited if it has less than 250 tons exceeding two thousand register. While, a fine not exceeding 5000 dollars and the aircraft or vessel detained until the fine is paid or security given is payable where an aircraft or of a vessel of 250 tons register or more is involved in this offence (Section 149(4)).

15. It is an offence concealing, smuggling, throwing overboard, destroying or staving any goods to prevent seizure; or importing, or carrying coastwise, or exporting any goods contrary to the East Africa Community Management Act 2004. Upon conviction a penalty not exceeding 7000 dollars and goods and the vessel forfeited if it has less than 250 tons exceeding two thousand register. While, a fine not exceeding 10,000 dollars and the aircraft or vessel detained until the fine is paid or security given is payable where an aircraft or of a vessel of 250 tons register or more is involved in this offence . Also in case of vehicle the person in charge of the vehicle is fined a penalty not exceeding 5000 dollars and the vehicle and goods forfeited (Section 199).

16. It is offence to imports, export, acquire, unload, or carry coastwise any prohibited, uncustomed or any restricted goods contrary to required conditions (b) unloads after importation or carriage coastwise. After conviction a penalty of 50% of the dutiable value involved is payable or a term not exceeding 5 years or both (Section 200).

17. It is an offence to imports or exports any concealed goods to deceive any officer. Upon conviction sentence not exceeding 5 years or to a fine equal to 50% of the value of the goods involved is payable (Section 202).

18. It is an offence making a false statements, providing incorrect/counterfeits information, obtaining any drawback, rebate, remission, or refund, or duty illegally, interfering illegally goods under customs, bringing into a partner state without lawful excuse any blank or incomplete invoice, bill head, or other similar document, capable of being filled up and used as an invoice for imported goods. After conviction a sentence not exceeding 3 years is served or a fine not exceeding 10,000 dollars is payable (Section 203).

19. It is an offence failing or refusing producing accounting records (Section 204).

20. It is an offence to cuts away, casts adrift, destroys, damages, defaces, or in any way interferes with, any aircraft, vessel, vehicle, buoy, anchor, chain, rope, mark, or other thing on customs enforcements. A fine not exceeding 2,500 dollars is payable after conviction (Section 205).

21. It is an offence failing to reports a discovery of any uncustomed goods on land or floating upon, or sunk in, the sea, to the nearest officer. After conviction a penalty not exceeding 2,500 dollars is payable besides forfeiting the goods involved (Section 206).

22. It an offence to aid, abets, counsel or procure the commission of any offence the doer commit the same offence and attract the same penalties under the offence (Section 208).

23. It is an offence seizing goods liable for forfeiture for personal gains, upon conviction a sentence not exceeding 3 years is served or a fine not exceeding 2000 dollars or to both (Section 213).

24. It is an offence declining to act as agent of a commissioner by giving false or misleading statement, or wilfully conceals any material fact upon conviction a fine not exceeding 2,500 dollars or sentence not more than 3 years or to both is imposed (Section 131 (7)).
25. It is an offence to imports, acquires, exports or carries coastwise any prohibited goods or any restricted goods against required conditions and uncustomed goods in whatever forms (Section 200). The penalty for this offence is a sentence not more than 5 years or a fine equal to 50% of the dutiable value involved, or both. Furthermore, in case of monetary penalty, the goods involved must be forfeited (Section 201).

26. Failure to leave the partner state as required without reasonable excuses attract, a penalty of not exceeding
2000 dollars and the vessel being forfeited if it has less than 250 tons register. Whereas, a fine not exceeding 5000 dollars and the aircraft or vessel detained until the fine is paid or security given is payable where an aircraft or of a vessel of 250 tons register or more is involved in this offence (Section 150(2)).

27. It is an offence to fail to provide food and accommodation of officer who is searching the vessel or aircraft for long period a fine of not exceeding 1000 dollars is payable (Section 152(3)).
28. It is an offence to temple with goods which are found on vessel or aircraft a penalty of equal to 10% of the dutiable value of the goods is payable (Section 152(6)).

29. It is offence to impersonalize a proper officer and opens, breaks, or in any way interferes with any lock, seal, mark or other fastening placed any building, room or place a sentence not exceeding 3 years is imposed of penalty not exceeding 2500 dollars is payable (Section 157). When goods disappear in a sealed premise the owner or occupier is liable to penalty of 25% of the value of the goods or to imprisonment for a term not exceeding five years (Section 157(5)).

12. Recovery Measures Used To Collect Unpaid Duties.

When customs taxes become due and payable but taxpayers fail to make good of it customs department has a number of options to recover the taxes due, including the following to enforce customs tax laws:

1. Instituting a civil legal debt claims on court of laws (Section 130(1)).

2. Detaining goods under customs control until duties are paid and after two months of detention goods might be sold to cover the duties (Section 130(2)).

3. Levying distress over goods, chattels and effects, material for manufacturing or plant of a factory, premises, animals, vehicles or other property of the debtors or their agents or other related persons when a duty is payable after court proceeding or a penalty is not paid one month after the due date of payment (Section 130(3)). The items distressed can be kept at owner's costs for 14 days or till the taxes and keeping costs are paid before those 14 days, otherwise the goods might be sold (Section 130(6)). Subsequently, the proceeds from the sale first goes to payment of the taxes due, second, to payment of any fine imposed for non-payment of the taxes, if any, third to payment of the expenses or other charges for levying of distress and for the sale and finally the balance of the proceeds if any, goes to the owner when the owner make application of the residual the Commissioner within 12 months from the date of the sale of the item (Section 130(7).

4. Appointing any person to be an agent of another person, where the former owes or is about to pay money to the latter, holds money for or on account of the latter, holds money on account or some other person for payment to the latter, has authority from some other person to pay money to the latter holds dutiable goods belonging to the latter. However, the appointed person if think cannot act as agent must inform the Commissioners of that decision by giving reasons. The appointed agent might be required to provide an account of any moneys or goods held by him/her within thirty 30 days from the date of notice. In addition, the notice may require the agent pay duty owed within thirty days of the date of service of the notice on him or her, or, of the date on which any moneys came into his or her hands or become due by him or her to his or her principal, whichever is the earlier. Failure to pay the duty as required, the owed duty become the liability of the appointed from the date when such duty should have been paid (Section 131).

5. Holding land or buildings as security for the duty or tax payable (Section 132).

Answer to Self-Test Question

Answer to TY 1

(a) The benefits of using a Customs Bonded Warehouse are: -

On-site storage;
Just-in-time delivery for both manufacture and general trade;
Less cash tied up in duties and taxes;
Deferred payment of taxes

(b) There are two (2) types of bonded warehouses. The are Private and Public Bonded Warehouses. The Private Warehouses are licensed for the storage of the licensee's goods while the general bonded warehouses are licensed to store goods for all traders.

(c) To be licensed, the applicant should make an application to the commissioner accompanied by a plan of the premises and its situation or location. The license will be issued on payment of the prescribed license fee if the Commissioner is satisfied that, the situation, construction of an accommodation in the premises proposed are suitable for use as a bonded warehouse. An annual license fee of US$1500 will be charged.

(d) No, the bonded warehouse license is not transferable

(e) The records kept in a bonded warehouse include but are not limited to; the name of the aircraft/vessel or the registration number of the vehicle which imported the goods as the case may be, the name of the importer, number of packages, value and particulars of the goods. In case of post parcel articles, the post parcel reference number will also be included.

Answer to TY 2

Determination of customs value using Transaction value method

	STG
Price paid	340,000
Brokerage charges	1,200
Selling Commissions	300
Buying Commissions (N/A)	-
Subsequent proceeds	120,000
Royalty	200

Wooden containers used for packing in England	500
Packing expenses in England	120
Tools and moulds	2,000
Freight	45,000
Insurance	17,000
	526,320

Answer to TY 3

- If the transaction value method (method 1) fails the next method to apply is the transaction value of identical goods (method 2)
- In case of identification of several transaction values of identical goods, the lowest value should be used to value the imported goods.
- Hence the customs value of the imported item =Tshs 40 million

Answer to TY 4

Determination of customs value using deductive value method

- The greatest number of units sold at a price is 100 so the unit price in the greatest aggregate quantity is 5,000,0000
- Hence customs value**=** Tshs 5,000,000 – 500,000 GE&P – 250,000 labeling = Tshs 4,250,000
- Duties and taxes are 25%
- X =Custom Value
  X + (X *0.25) = Tshsh 4,250,000
  4,250,000 / 1.25 = Tshs 3,400,000
- Therefore customs value = Tshs 3,400,000

Answer to TY 5

Determination of customs value using computed value method

	US $
Production costs	
Direct labour	400
Direct materials	600
Overheads and profit	320
Freight	600
Insurance	200
Customs value	2,120

Answer to TY 6

(ii) Calculation of CIF/Customs value

FOB price	20,000
Freight Charges	1,500
C&F	21,500
Insurance	100
CIF/customs value	21,600
Exchange rate	2,000
CIF/customs value in Tshs	43,200,000

(iii) Calculation of duties and taxes

Customs value of imported goods	**43,200,000**	
Import duty (25% x 43,200,000)	10,800,000	10,800,000
Tax base for excise duty(EDB)	**54,000,000**	
Excise duties on engine capacity (20% x 54,000,000)	10,800,000	10,800,000
Excise duties on age (5% x 54,000,000)	2,700,000	
	67,500,000	
Railway and Development levy(1.5%x 43,200,000)	648,000	648,000
Tax base for VAT(VB)	**68,148,000**	
Value added tax (18%*68,148,000)	12,266,640	12,266,640
Total duties and taxes		**34,514,640**

Answer to TY 7

Four possible reasons for imposition of import duty on imported goods

1. To safeguard local industries
2. Security reasons
3. To safeguard endangered species
4. Agricultural reasons
5. To raise government revenue

Self-Examination Question

Question 1

Mizengwe Importers Ltd (MIL) of Tanga Tanzania, imported goods that are as per East African Community Customs Management Act (EACCMA) 2004, restricted goods. MIL did observe all requirements regarding importation of restricted goods. Such goods arrived at Tanga Port on January 3, 2018. The Commissioner of Customs gave several notices and decided to sell the goods by public auction. The goods were sold for Tshs22,700,000. MIL had the following obligations to settle:

Duties due to customs	Tshs12,500,000
Port charges of	Tshs4,500,000
Freight and other charges	Tshs13,800,000
Expenses of removal and sale of goods of	Tshs2,600,000
Clearing and forwarding charges	Tshs670,000
Rent and charges due to customs	Tshs8,800,000

Required

(a) Given the above receipts and obligations, determine how the proceeds of sale may be distributed

(b) To whom the balance, if any, is supposed to be paid to?

Question 2

Tabora Gold Traders of Tabora Tanzania imported used goods from Taiwan. The cost of the car includes:

Cost (FOB)	USD 3,500
Sea freight	USD 1,800
Insurance	USD 100

Upon arrival of the car at Dar es Salaam, Harbour on March 29, 2018 the customs offices issued assessment that in fact was based on the customs value that is higher than the actual CIF value by 10%. The following rates were applicable at the date of assessing the car for duty and taxes purposes.

Import duty on the car 20%

Excise duty on the car 5%

Value Added Tax 18%

Railways and development levy 1.5%

Exchange rate Tshs 2,200 per USD

Required:

(a) Compute the customs value in USD had the customs office not uplifted the value of the goods
(b) Compute total duties and taxes payable based on uplifted value in Tanzania shillings.

Question 3
Define the following terms as applied in reference to the East African Community Customs Management Act, (EACCMA) 2004.

(i) Sufferance Wharf

(ii) Duty Draw back

(iii) Export Processing Zone (EPZ)

Question 4
Ndala imported an item from Japan. On the arrival of the item, Ndala could not produce valid documents acceptable by the Customs Department. For that case, Customs Officers came out with the following values for such imported item:

Values for identical items:
A – Tshs.40 million
B – Tshs.50 million
C – Tshs.45 million

Values for similar items:
D – Tshs.30 million
E – Tshs.35 million
F – Tshs.60 million

The cargo is subject to 25% import duty, 10% excise duty and 18% VAT and 1.5% Railway and development levy.

Required

Compute the amount of import duty, excise duty and VAT on importation of this item.

Question 5
For the purpose of determining the value for duty purposes for customs duty on imported goods, there are six methods that are used. The basic method used is known as the transaction value method.

Required:

(i) Explain what is meant by transaction value for customs duty purpose.
(ii) State four (4) conditions that should be met in order for the transaction value method to be used.
(iii) Describe three (3) other methods that may be used to value imported goods.

Question 6

(a) Briefly describe any **FIVE** goods which are under custom control as stipulated in the East African Community Customs Management Act, 2004

(b) Briefly explain what is Customs Union and outline any five main features of the recently formed EAC Customs Union.

Question 7

(a) Mention any four types of entries for imported goods as stipulated under section 34 of the East African Community Customs Management Act 2004.

(b) Briefly explain how the value of goods for export is determined as per the East African Community Customs Management (EACCM) Act 2004.

Question 8

(a) Explain briefly, four duties of bonded warehouse officer.

(b) Rules of origin are the criteria needed to determine the national source of a product. Their importance is derived from the fact that duties and restrictions in several cases depend upon the source of imports. The East African Community (EAC) has its origin criteria which are used to determine the source of goods.

Required:

Discuss the origin criteria which determine where the goods originate within East African Community member states.

Question 9

(a) Giving at least one example, briefly explain the term "economic integration".

(b) Explain the stages of economic integration

(c) For the purpose of prevention of smuggling, the EAC Customs Management Act 2004 grants several powers for customs proper officers to effect the provisions of the Act in this regard.

Required:

State four powers granted to the proper officer for prevention of smuggling.

(d) State the conditions that must be satisfied for temporary imports to be exempted from import duty.

Question 10

(a) The Second Schedule of the EAC Customs Management Act, 2004, contains a list of prohibited goods and restricted goods.

Required:

With examples, provide a brief explanation of the following terms:

(i) Prohibited goods

(ii) Restricted goods

(b) Explain five reasons for imposition of import prohibitions and restrictions.

Question 11

"Smuggling of goods to and from neighbouring countries is a problem to the Tanzania economy".

REQUIRED

(a) Explain with reasons why illegal cross border trade or business has thrived despite government measures and efforts to prevent it.

(b) Suggest ways and means which may help to prevent the problem of smuggling across Tanzania national borders.

(c) Describe briefly the powers of Customs' Officers and their agents to prevent smuggling.

Question 12

(a) All transit goods are under customs control and the Commissioner General appoints roads or routes in the country over which goods in transit shall be conveyed. Why is customs control of transit goods necessary?

(b) Differentiate between 'green channel' and 'red channel' as used in the East African Community Customs Management Act, 2004

(c) Mention any four possible reasons for imposition of import duty on imported goods.

Question 13

(a) Briefly describe the role of the customs and excise department of the Tanzania Revenue Authority (TRA).

(b) Mention four (4) taxes on international trade that are administered by the customs and excise department.

(c) The East African Community Customs Management Act, 2004 is resourceful on the procedures to be followed for movement of goods, persons and means of transport directly incoming or outgoing from a partner state passing from one partner state to another from foreign and between members of the partner states.

Required:

(i) What do you understand by Carriage coastwise and transfer of goods?

(ii) What are the provisions under East African Community Customs Management Act, 2004 dealing with loading and transfer of goods coastwise?

Question 14

Bonded warehousing is one of the ways by which the Commissioner for Customs and Excise facilitates trade as it helps to improve the liquidity position of importers by making it possible for import duties to be payable on small quantities that are withdrawn from the bonded warehouses.

Required

(1) Define the following terms in relation to import duties: -

(i) Bonded Warehouse

(ii) Customs Warehouse

(iii) Bond

(2)Identify any four types of goods that are not allowed to be deposited in bonded warehouses.

(3)All transit goods are under customs control and the Commissioner General appoints roads or routes in the country over which goods in transit shall be conveyed. Why is customs control of transit goods necessary?

Question 15

Explain the following terms as used in customs valuation of imported goods liable to ad-valorem import duty:

(i) Transaction value

(ii) Transaction value of similar goods

(iii) Deductive value

(iv) Computed value

Question 16

Importation of courier and post parcels items is governed by Section 36(1b) of the East African Community Customs Management Act (EACCMA), 2004 (Revised in 2009).

Required:

(a) Describe clearance procedure of post parcel as per the East African Community Customs Management Act (EACCMA), 2004 (Revised in 2009).

(b) What are the main challenges faced in the process of importing/exporting courier and post parcel items in Tanzania?

Answer to SEQ 1

(i) There is order of payment is presented in the table below.

I t e	**Tshs**
Proceeds	22,700,000
Order of payments:	
Duties	12,500,000
Balance	**10,200,000**
Removal and sales expenses	2,600,000
Balance	**7,600,000**
Rent and other expenses at warehouse	7,600,000
Balance	**-**
Port charges	-
Freight charges	-
Others expenses	-

(viii) There is no balance left as the proceeds cannot cover all of the expenses

Answer to SEQ 2

(a) Customs values of imported goods in USD without uplifting

	USD
Cost	3,500
Freight	1,800
Insurance	100
Total	**5,400**

(b) Compute total duties and taxes payable based on uplifted value in Tanzania shillings.

Un-uplifted customs value	5,400
Uplifting (10% ×5,400)	540
Uplifted value	**5,940**
Exchange rates	2,200
Uplifted customs value in Tshs	**13,068,000**
Import duty (20%×13,068,000)	2,613,600
	15,681,600
Excise duty(5% ×15,681,600)	784,080
	16,465,680
Railway and development(1.5%×13,068,000)	196,020
	16,661,700
Value added tax(18%×16,712,665)	2,999,106

Answer to SEQ 3

(i) Sufferance wharf means any place, other than an approved place of loading or unloading at which the Commissioner may allow any goods to be loaded or unloaded.

(ii) Duty drawback means a refund of all or part of any import duty paid in respect of goods exported or used in a manner or for a purpose prescribed as a condition for granting duty drawback.

(iii) Export processing zone means a designated part of customs territory where any goods introduced are generally regarded, in so far as import duties and taxes are concerned, as being outside Customs territory but are restricted by controlled access.

Answer to SEQ 4

Customs value	**40,000,000**	
Import duty (25%×40,000,000)	10,000,000	10,000,000
	50,000,000	
Excise duty(10% ×50,000,000)	5,000,000	5,000,000
	55,000,000	
Railway and development(1.5%×40,000,000)	600,000	600,000
	55,600,000	
Value added tax(18%×55,600,000)	10,008,000	10,008,000
		25,608,000

Answer to SEQ 5

(i) The term transaction value is used to refer to the actual price paid or payable in respect of imported goods, including insurance, freight and other incidental charges to the extent that they have been paid.

(ii) In order for the transaction value to be used for customs duty purposes, the following conditions should be met.

- There should be no restrictions to the use of the goods.
- There should be no conditions to deter the determination of the VDP
- No part of the proceeds on resale would accrue to seller, unless included in the value.
- No relationship exists to influence the value.

(iii) Three other methods that may be used to value imported goods include:

- **Transaction value of identical goods**-this is the price of identical goods imported by another importer into Tanzania from the same source including insurance, freight and other incidental costs.
- **Transaction value of similar goods**. This is the price of similar goods imported by another importer into Tanzania from the same source, including, insurance, freight and other incidental costs.
- **Deductive Value**-this is the price at which identical or similar goods are sold in their quantity in Tanzania.
- **Computed value-** this is the price based on the cost of production, insurance, freight and other incidental costs.

Answer to SEQ 6

(a) **The following goods shall be subject to Customs control**

(i) Imported goods, including goods imported through the Post Office, from the time of importation until delivery for home consumption or until exportation, whichever first happens;

(ii) Goods under duty drawback from the time of the claim for duty drawback until exportation;

(iii) Goods subject to any export duty from the time when the goods are brought to any port or place for exportation until exportation;

(i) Goods subject to any restriction on exportation from the time the goods are brought to any port or place for exportation until exportation;

(ii) Goods which are with the permission of the proper officer;

(iii) Goods on board of any aircraft or vessel whilst within any part or place in a Partner States;

(iv) Imported goods subject to duty where there is a change of ownership over such goods from an exempt person to a non-exempt person.

(b) The Customs Union is the first stage in the process of economic integration though in theory of economic integration; A Customs Union is supposed to be the third stage of integration after Preferential Trade Area and a Free Trade Area. The EAC Treat provides that the Customs Union shall be followed by the Common Market then a Monetary Union and subsequently a Political Federation. The EAC Customs Union encompasses three States; Uganda, Kenya, and Tanzania.

The main features of a Customs Union include the following (any five):

(i) A common set of import duty rates applied on goods from third countries (Common External Tariff, (CET);

(ii) Duty-free and quota-free movement of tradable goods among its constituent customs territories;

(iii) Common safety measures for regulating the importation of goods from third parties such as phyto-sanitary requirements and food standards.

(iv) A common set of customs rules and procedures including documentation;

(v) A common coding and description of tradable goods (common tariff nomenclature; CTN);

(vi) A common valuation method for tradable goods for tax (duty) purposes (common valuation system);

(vii) A structure for collective administration of the Customs Union.

(viii) A common trade policy that guides the trading relationships with third countries/trading blocs outside the Customs Union i.e. guidelines for entering into preferential trading arrangements such as Free Trade Area's etc. with third parties.

Answer to SEQ 7

(a) The following are types of entries according to section 34 of the East African Customs management Act:

(i) Entry for Home consumption
(ii) Entry for warehousing
(iii) Entry for transhipment
(iv) Entry for Transit and
(v) Entry for Export processing zone

(b) The value of goods for export shall include:

(1) (i) Cost of the goods and

(ii) Transport and all other charges up to the time of delivery of the goods on board the exporting aircraft or vessel or at the place of exit from the Partner state

(2) Where cost of the goods cannot be determined, the cost of similar or identical goods exported from a Partner State at or about the same time.

(3) Where the value of the goods cannot be determined under (1) & (2) above, then the proper officer may determine the value of such goods

Answer to SEQ 8

(a) Any four duties of bonded warehouse officer:

(i) To ensure that warehouse licensee gives delivery of goods only against approved warrants.

(ii) To ensure that the landing Account Books are being kept securely, properly maintained and up to date all the times.

(iii) The weekly submission of certificate of receipt

(iv) To ensure that the warehouse keeper complies with all provisions related to warehousing of goods as per EACCMA 2004

(v) To notify the collector of the failure to deposit goods so entered within the prescribed period.

(vi) To ensure that all damaged and slack packages are reported at once in view of speedy repair

(vii) Ensuring that all goods entered for warehousing are deposited into warehouse

(b) Goods shall be accepted as originating in a Partner State where they are consigned directly from a Partner State to a consignee in another Partner State and where:

(i) they have been wholly produced as provided for in Rule 5 of these Rules;

(ii) they have been produced in a Partner State wholly or partially from materials imported from outside the Partner State or of undetermined origin by a process of production which effects a substantial transformation of those materials such that:

(iii) the c.i.f. value of those materials does not exceed sixty per centum of the total cost of the materials used in the production of the goods:

- the value added resulting from the process of production accounts for at least thirty five per centum of the ex-factory cost of the goods as specified in the First Schedule to these Rules; and

(iv) the goods are classified or become classifiable under a tariff heading other than the tariff heading under which they were imported as specified in the Second Schedule to these Rules.;

Answer to SEQ 9

(a) Economic integration refers to the action of a group of nations towards elimination of all or some of barriers to trade. Economic integration includes also cooperation in some economic affairs jointly by member countries.

Examples of economic integration are EAC, COMESA, SADC, ECOWAS or any other relevant example.

(b) Stages of economic integration are formation of:

(i) Free trade area, that is; where the member countries agree to reduce the barriers to trade and among themselves, whereas member country is free to impose any barrier to countries which are non-members.

(ii) Customs union where member countries remove all trade barriers among themselves and impose a common external tariff to non-member countries.

(iii) Common market which is a stage of economic integration where in addition to meeting requirements of the customs union there is free mobility of factors of production such as labor between member countries.

(iv) Total or political integration which is a stage where member countries cooperate in all economic and political matters. Example is having one assembly, one president, etc.

(c) In sections 149-159 the EAC Customs Management Act 2004 grants the following powers to the proper officer:

- Power to board vessels
- Power to require vessels to depart
- Power to search premises
- Power to enter upon and patrol and pass freely along premises other than dwelling house
- Power to search persons
- Power to arrest
- Power to require production of books
- Power to stop vehicle suspected of conveying un-customed goods.

(d) The conditions that must be satisfied for temporary imports to be exempted from import duty:

- The proper officer is satisfied that the goods are imported for temporary use;
- The owner pays appropriate deposit or provides security;
- The goods are exported within 12 months from the date of importation.

Answer to SEQ 10

(a) Prohibited Vs Restricted Goods

(i) Prohibited goods are those goods whose importation is not allowed. Examples include sedition materials, pornographic materials and narcotics

(ii) Restricted goods: are those goods whose importation is not allowed unless certain conditions are made. Examples include tortoise shells, arms and ammunition, and nuclear reactors.

(b) Reasons for imposition of prohibitions and restrictions

- **Political reasons**: Importations of seditious publications that may entice the public to revolt from lawfully elected government are prohibited, for political reasons

- **Economic reasons**: Importation of false money and counterfeit currency notes and coins is prohibited, for their adverse impact on performance of the economy.

- **Social reasons**: Importation of pornographic materials in all kinds of media, indecent or obscene prints are prohibited, for their negative effect on morals.

- **Security reasons**: Importation of lethal weapons, silencers, fire arms, and flick knives are prohibited for the danger they pose to security.

- **Health reasons**: Importation of dangerous drugs, such as drugs of abuse is prohibited unless imported by a specialized institution such as a Hospital, Laboratory or Health Centre approved by the Ministry of Health.

- **Agricultural reasons**: The importation of plants, seedlings, seeds of sowing and game animals is restricted for agricultural development reasons.

Answer to SEQ 11

It is true to say that smuggling is a serious problem to the Tanzanian economy because it results into ***tax loss*** to the government; it ***creates shortages*** of goods which ***results into high prices*** for the reduced supply of goods in the country from which the goods are smuggled. Also, it creates corruption and weak enforcement machinery, hence low probability of detection.

(a) **Reasons for smuggling**:

- Availability or non-availability of goods in one part of the border.
- Price differentials of goods between countries. Goods will move from low price area to high price area.
- Government restrictions on cross-border trade (absence of free trade).
- Cumbersome/difficult import regulations and high import duty.

(b) Ways and means to prevent smuggling:

- Allow free trade. Formation of the East Africa Community (EAC) is a step in the right direction.

- Eliminate or lower import duty and simplify import regulations.
- Increase efficiency of TRA to prevent smuggling and tax evasion by apprehending smugglers and punishing them.
- Increase the level of production as a long-term solution.

(c) Powers of Customs Officers to prevent smuggling.

- Apprehend smugglers
- Impound smuggled goods and auction them.
- Impose fines, penalties and prosecute smugglers.

Answer to SEQ 12

(a) Customs control of transit goods is necessary to ensure that goods that are destined to foreign countries through the territory of the United Republic of Tanzania are not entered for home consumption.

(b) Green channel means that part of the exit from any customs arrival area where passengers arrive with goods in quantities or values not exceeding those admissible; while Red channel means that part of the exit from any customs arrival area where passengers arrive with goods in quantities or values exceeding passenger allowance.

(c) Four possible reasons for imposition of import duty on imported goods

6. To safeguard local industries
7. Security reasons
8. To safeguard endangered species
9. Agricultural reasons
10. To raise government revenue

Answer to SEQ 13

(a) **Role played by customs and Excise Department in Tanzania**.

Customs and Excise Department administers all taxes and duties on international trade in accordance with the Customs and Excise laws of the country. It also has a responsibility of controlling prohibited and restricted items/goods imported into the country through the borders, seaports and airports. The department is also responsible for compilation of trade statistics and facilitation of intentional trade.

(b) Taxes on international trade administered by the Customs and Excise Department are:

- Import duty
- Excise Duty on imports
- Valued Added Tax on import, and
- Suspended Duties (additional Duties on certain imported goods to address dumping practices.

(c) (i) Carriage coastwise when goods conveyed by land, by air or by sea from any part of partner states to any other part thereof are deemed to be carried coastwise any aircraft or vessel, whether in ballast or conveying such goods by air or by sea shall be deemed to be as coasting aircraft or coasting vessel as the case may be.

(ii) Conditions under section 99 of EACCMA,2004 dealing with loading and transfer of goods coastwise are:

- Goods shall not be loaded or unloaded from aircraft or vessel for carriage coastwise at any time what so ever except as prescribed by the commissioner.
- Goods for carriage coastwise or transfer shall not be unloaded from or loaded on to any aircraft or vessel except at an approved place of loading or sufferance wharf.
- All goods, which have been unloaded or landed from coasting vessel or coasting aircraft, shall if the proper officer require, be conveyed forthwith to a Customs area or transit shed.

- All goods which have been transferred by road shall if the proper officer so requires be conveyed forthwith to Customs house or to such other place as the proper officer may direct.

(iii) As per section 105

- An officer may go on board any coasting aircraft or vessel in any port place in a partner states or at any period of voyage of such aircraft or vessel and search the vessel and examine all goods on board.
- Proper officer may require master or agent thereof to answer questions concerning aircraft or vessel, its cargo, stores, baggage crew, passengers and to produce any document, which should be on board.
- An officer may examine goods, which have been unloaded from any aircraft or vessels after carriage coastwise.

(iv) Transire is a document used as manifest to carry goods coastwise or transfer of goods coastwise as in accordance with section 98. For the control purposes, the master or agent of any aircraft or vessel intending to depart coastwise or carrying good for transfer , shall deliver to the proper officer the transpire for the carriage of the goods specified therein. This is normally used as the certificate of clearance for such aircraft or vessel for the coastwise voyage.

Answer to SEQ 14

(i) Definitions

- A bonded Warehouse is any warehouse licensed by the Commissioner for Customs and Excise for the deposit of dutiable goods on which duty has not been paid, and which have been entered for warehousing.
- A Customs Warehouse is any place approved by the Commissioner for Customs and Excise for the deposit of un-entered, un-examined, detained or seized goods for the security of those goods or for the security of duty payable on them.
- A bond is a legal contract executed under seal whereby parties to such contract bind themselves to pay a specified amount of money if any of the conditions of the contract are not fulfilled.

(ii) Goods not allowed to be deposited in bonded warehouses are:

- Duty free goods
- Goods of combustible or inflammable nature (except petroleum products under specified conditions)
- Acids, arms and ammunition for trade and explosives
- Goods whose duty has already been paid
- Bulk goods of low value e.g. sand, stones, ashes, clay etc.
- Any goods that the proper officer may consider unsuitable for warehousing.

(iii) Customs control of transit goods is necessary to ensure that goods that are destined to foreign countries through the territory of the United Republic of Tanzania are not entered for home consumption.

Answer to SEQ 15

(i) **Transaction value of imported goods** is the price actually paid or payable for the goods when sold for export to the partner state adjusted according to adjustments stipulated under paragraph 9 of the 4th schedule to the EAC Customs Management Act 2004.

(ii) **Transaction value of similar goods:** According to paragraph 4 of the 4th schedule of the Act mentioned in (i) above, is the price of similar goods imported to Partner States at or about the same time as the goods being valued. It is used when transaction value and transaction value of identical goods are not available. If more than one transaction value is found, the lowest value should be used. Adjustment is required to be made to take account of significant differences in cost and charges between the imported goods and the similar goods in question arising from differences in distances and modes of transport if costs and charge, under paragraph 9(2) are included in the transaction value.

(iii) **Deductive Value:** This is the unit price at which the imported goods or identical or similar imported goods are so sold in the greatest aggregate quantity at or about the time of the importation of the goods being valued to the persons who are not related to the persons from whom they buy such goods subject to deductions for the following:

- Sales Commission paid/payable
- Profit added
- General expenses added
- Transport, insurance at other related costs incurred in Partner States.
- Customs duties and other national taxes payable in Partner States by reason of importation or sale of goods.
- Costs and charges under paragraph 9(2) of the 4th schedule of EAC Customs Management Act 2004 where appropriate**.**

(iv) **Computed Value:** This is the value obtained by computing the cost of production in the country of supply (export) basing on the following (i.e. total of the following):

- Cost of materials or other processing employed in producing the goods.
- The profit and general expenses usually reflected in the sales of goods of the same class or kind in the country of exportation.

The cost or value of all other expenses necessary to reflect the costs added under paragraph 9(2) e.g. loading, handling and related charges, and transport and insurance costs in the country of export.

Answer to SEQ 16

(a) Clearance Procedure of Post Parcel

- Postal Office records all imported or goods intended to be exported through Post Parcel advice (Form P 195)
- Original copy of form P 195 is sent to the Addressee
- Duplicate copy is sent to Customs for Clearance
- Counterfoil remains with Postal authority for record purpose
- On receipt of Duplicate P195 form, Customs records details shown on form P195 in a register.
- On the side of the importer, upon receipt of the original copy of P 195 from the post office he/she submits a photocopy of his/her identity card to the Post office
- The postal office brings the parcel to Customs Counter
- The importer lodges declaration (form CN23), P 195, invoice, packing list and permit (if required) at the Customs counter.
- Customs officer examines the documents and the parcel to verify type of goods, quantity, weight and value in the presence of the owner and the Postal official.
- Customs officer issue tax assessment Importer pays the assessed taxes and is
- Issued with a TRA Receipt and duplicate P 195.
- Importer present TRA receipt and duplicate P 195 to Post office which releases the parcel.

(b) Challenges faced in the process of importing/exporting courier and post parcel items in Tanzania.

- Delay in clearance of parcels which needs import/export permits from other government institutions (OGD's)
- Most OGD's such as Tanzania Food and Drug Authority (TFDA, Private Health Laboratory Board (PHLB), Government Chemistry and Laboratory Agents (GCLA) do not work on Saturday thus delaying processing of goods imported by Courier companies.
- Review of de-minimus value
- The minimum threshold value or deminimus value currently applicable for cargo imported in Tanzania of US$3 is very low and is not trade facilitative. This is because the large percentage of items imported by courier services companies have low values ranging from US$5-20. Although the value are very low, we're required by the law to collect duties and taxes on them.
- Delay caused by frequent power cut off and system down time
- Growth of e-business
- Non automation of post offices and OGDs.
- Appointment of Clearing agents firms to clear items imported by courier companies.
- With exception of DHL which has its own Clearing house the remaining courier companies use different Clearing agents firms to clear their goods (Some of these Clearing agents firms make their own documents to reduce duty and tax liability thus prolonging clearance time).

SECTION H

OTHER INDIRECT TAXES

H1

STUDY GUIDE H1: EXCISE DUTY

Get Through Intro

Nowadays when the world economy is in the state of recession or slow increase in the economic growth and individual countries face high deficits of the public finance, ways how to seal the hole in the state budget are sought for. Governments can either use restrictive measures by lowering the public expenditures or they can increase the state budget revenues by increasing the tax rates. One favorite way of each government is to increase the tax rates on products, which have the lowest effect on reducing their consumption. Such products include for example, alcohol, tobacco or petrol, in other words, products liable to excise taxes. This study guide describe the nature and objectives of excise taxes, it also discuss items liable for excise taxes.

Learning Outcomes

a) Describe the nature and objectives of Excise Taxes,
b) Describe methods of charging excise taxes
c) Explain items liable for excise taxes in Tanzania

Describe the nature and objectives of Excise Taxes. **[Learning outcome a]**

1. The Nature And Objectives Of Excise Taxes

1.1 Definition

Excise duty is an indirect tax imposed on specific goods and services manufactured locally or imported which are consumed within a country. Tax can be collected from the producer, manufacturer, wholesaler, importer, or at the point of final sale to the consumer. Excise taxes can be either **specific** or **ad valorem**. Specific excise taxes are charged per quantity, such as per cigarette, pack, or kilogram (e.g., Tshs 1.50 per pack regardless of price). **Ad valorem** excise taxes are charged as a percentage of the value of the product.

1.2 Objective of excise duty

There are several arguments in favor and against the implications of excise taxes, the main reasons for levying excise taxes are:

First to**, generate revenues** with relatively low administrative costs. Since most excise taxes are specific, these can be levied on goods and services with inelastic demand. Moreover, to reduce the cost of collection, products which are homogeneous and have a small number of producers could be easily taxed.

Second, excises are considered to be **corrective taxes,** as they may be imposed to correct the external effects produced by the consumption of certain goods. This tax tries to internalize the external cost of its consumption. For instance, taxes levied on alcoholic beverages and tobacco products are imposed to alleviate the external costs produced by car accidents, lung cancer treatment financed through public funds. Excises on motor fuels are to curb pollution and road congestion generated by vehicles.

Describe methods of charging excise taxes [Learning outcome b]

2. Methods Of Charging Excise Taxes

There are two main methods

(i) Specific rate method

If the tax is levied as an amount per unit of a good (e.g. Afs. per box), the tax is called per unit or specific. The unit of the good can be measured in weight, volume, or length. The basic way to calculate the tax would be:

Tax liability = Quantity * Tax per unit = Q * T

The disadvantage with a per unit tax system is that as prices of goods and services increase over time (with inflation), the tax revenue remains the same. If the tax collections are measured in real terms the tax revenue decreases over time.

(ii) Ad-valorem tax rate method.-

In an ad-valorem tax rate structure, the excise tax is levied on value. The tax rate is a percentage of the price of the good or service. Thus, when the price of the good or service goes up, the tax revenue also goes up. The ad-valorem tax rate structure takes care of the frequent increases in prices and does not require indexing of the rate as is the case with the unit tax rate system. However, it is very important that in the ad-valorem system, the price to be used is chosen carefully.

Explain items liable for excise taxes in Tanzania [Learning outcome c]

3. Items Liable For Excise Taxes In Tanzania

3.1 Items charged under specific rates include:

Wine, spirits, beer, soft drinks, mineral water, fruit juices, Recorded DVD,VCD,CD and audio tapes, cigarettes, tobacco, petroleum products, Natural gas and telecommunication sim cards.

3.2 Items charged under ad-valorem rates include:

Money transfer services, electronic communication services, pay to view television services, imported furniture, motor vehicles, plastic bags, specified aircrafts, firearms, specified cases, cosmetics and medicaments.

Ad-valorem rates are: 0%, 0.15%, 5%, 10%, 14.5%, 15%, 20%, 25% and 50%.

Self-Examination Questions

Question 1

(a) Explain the term "Excise Duty".

(b) What is the rationale for imposing excise duty on goods?

Question 2

(a) What is excise duty?

(b) State any three (3) types of goods or services where excise duty is levied on.

Question 3

(a) What is the difference between specific and ad valorem duty charging basis?

(b) Identify four major problems of the specific excise taxes in relation to the alcoholic beverages.

Answers to Self-Examination Questions

Answer to SEQ 1

(a) Excise duty is an indirect tax imposed on specific goods and services manufactured locally or imported which are consumed within a country. An excise duty is a tax levied on consumption of some selected goods such as spirits, alcohol and tobacco that are manufactured within the country. It is money paid to the government by manufacturing concerns or importer on goods produced or imported.

(b) Rationale for Imposing Excise Duties

- Excise duty plays important role in the fiscal policies of government. It is therefore a fiscal weapon that can be manipulated to achieve predetermined economic objectives.
- It has high capacity for re-allocating income.
- Excise duty can be used to influence the exercise of purchasing power by consumers.
- Excise duty has an import substitution effect, this is because, rates of excise duty are sometimes reduced or completely eliminated in order to give impetus to local production activities.
- Excise duty can be used to discourage the proliferation of industrial development along certain lines to the exclusion of others. For instance, it may be increased on certain commodities to deter investors.

Answer to SEQ 2

(a) Excise duty is a tax on particular goods or products which are normally luxuries. The duty is imposed on domestic or imported goods by reference to such things as weight, quantity or value.

(b) Three types of goods where excise duty is levied on include:-

- Cigarettes
- Imported furniture
- Wines
- Petroleum products
- Spirits
- Beer
- Soft drinks

Answer to SEQ 3

(c) Difference between specific and ad valorem duty**.**
Ad valorem is duty that is based on the value of goods while a specific duty is duty charged on measures like weight or volume of goods.

(d)

(i) Specific taxes may prove "sticky"-difficult to change in the face of inflation, with the result that real revenues may fall in the face of price increases. Since a principal motivation for differently higher taxes on alcohol is to raise public revenues in a relatively efficient way, this is clear a disadvantage. Specific taxes may also discriminate against relatively cheaper products-since the tax will make up a large a proportion of the final price, the lower that price happens to be and this may be considered undesirable, for example, because such products are mostly consumed by low-income people.

(ii) Specific taxes are often levied on "one unit of the good" which may be difficult to define. Is one unit a litre of beer or a litre of the alcohol component of the beer or some combination of two?

(iii) Since specific taxation is based on some physical characteristics of the product the tax may not tax the value of the alcohol to the consumer. For example, the packaging or convenience of availability would not be considered in a typical specific tax on alcohol.

(iv) Moreover, specific taxes are also subject to an "upgrading effect" in the sense that when a specific tax rate is increased, consumers may increase their demand for the untaxed amenities of the beverages such as better packaging.

SECTION H

OTHER INDIRECT TAXES

H2

STUDY GUIDE H2: STAMP DUTIES

Get Through Intro

It is important to stamp instruments; otherwise, such instrument will not be accepted in criminal cases proceedings, be admitted in evidence or be available for whatsoever in a claim for title or rights. This guide the nature and objectives of stamp duty, it also outline instruments chargeable to stamp duty.

Learning Outcomes

a) Explain the nature and objectives of stamp duties
b) Outline the Instruments Chargeable
c) Outline the stamp duties rates and the basis of computation

Explain the nature and objectives of stamp duties [Learning outcome a]

1. **Nature And Objectives Of Stamp Duties**

   Stamp duties are duties basically on instruments (defined as to includes every document by which any right or liability is, or purports to be, created, transferred, limited, extended, extinguished or recorded).The duties are either specific (fixed) or ad valorem. It is important to stamp instruments; otherwise, such instrument will not except in criminal cases proceedings, be admitted in evidence or be available for whatsoever in a claim for title or rights. Stamp duty are governed by Stamp Duty Act, Cap 189, which provides for levying of stamp duties on certain documents and matters specified in the Act.

   1.1 Time when instrument must be stamped

   All chargeable instruments executed by any person in Tanzania Mainland shall be stamped within thirty days of execution.

Outline the instruments chargeable to stamp duties [Learning outcome b]

2. **Instruments Chargeable To Stamp Duties**

   The instrument chargeable to stamp duty are specified in the schedule provided they are executed in Tanzania mainland or if executed outside Tanzania relates to any property or any matter or thing performed in Tanzania. The Stamp Duty Act specifies the persons to pay stamp duty where in most cases it is payable by the person drawing, making, or executing the instrument. Where, in the case of any sale, mortgage or settlement, several instruments are employed for completing the transaction (whether executed at the same time or at different times) the principal instrument only shall be chargeable with the duty prescribed in the Schedule to this Act for the conveyance, mortgage or settlement, as the case may be, and each of the other instruments shall be chargeable with a duty of one thousand five hundred shillings instead of the duty (if any) prescribed for it in that Schedule. When a person is in doubt as to whether or not an instrument is required to be stamped or as to the amount of the Stamp Duty payable in respect of any instrument, he can refer the matter to the Stamp Duty Officer for adjudication.

Outline the stamp duties rates and the basis of computation [Learning outcome c]

3. Stamp Duties Rates And The Basis Of Computation

The duties are either specific (fixed) or ad valorem

(i) Specific /fixed

These are duties that do not vary with the value of the consideration on the document that is subject to the stamp. In other words the duty is payable irrespective of the value on the instrument.

Instruments that attract specific duties includes

- Affidavit
- Cheque
- Valuation
- Power of attorney
- Agreement or memorandum of agreement

(ii) Ad valorem

These are duties that vary with value of the consideration on the document that is subject to the stamp. Instruments attract ad valorem duties include

- Lease documents
- Transfers of shares
- Transfer of debentures etc

3.1 Rates Applicable to instruments

Stamp duty is charged on specified instruments at varying rates. Some few common instruments and their duty rates are as follows:

Description of Instruments	*Proper Stamp Duty*
AFFIDAVIT, Including an affirmation or declaration in the case of persons by law allowed to affirm or declare instead of taking oath.	Tshs. 500/=
AGREEMENT OR MEMORANDUM OF AGREEMENT	Tshs. 500/=
AGREEMENT RELATING TO DEPOSIT OF TITLE DEEDS, HYPOTHECATION, PAWN OR PLEDGE,	Tshs. 500/=
APPRAISEMENT OR VALUATION, made otherwise than under an order of the Court in the course of a suit:	Tshs.500/=
Instrument of EXCHANGE OF PROPERTY	0.5 percent for the first TSHS. 100,000/=, then 1 percent of value in excess of TSHS. 100,000/=
LEASE, including an under-lease or sublease and any agreement to let or sublet:	1 percent of the annual reserved rent for lease of all durations
MEMORANDUM OF ASSOCIATION OF A COMPANY	Tshs. 5,000/=

POWER OF ATTORNEY,	Tshs. 500/=
DIVORCE, INSTRUMENT OF, that is to say, any instrument by which any person effects the dissolution of his marriage	TShs.500/=
EXCHANGE OF PROPERTY	0.5 percent for the first TShs. 100,000/=, then 1 percent of value in excess of TShs. 100,000/=
LETTER OF CREDIT, that is to say, any instrument by which one person authorises another to give credit to the person in whose favour it is drawn.	TShs. 500/=
LETTER OF LICENCE, that is to say, any agreement between a debtor and his creditors that the latter shall for a specified time suspend their claims and allow the debtor to carry on business at his own discretion.	TShs. 500/=
CUSTOMS BOND: (a) Where the amount does not exceed TShs. 9,999/=. (b) In any other case. the maximum should not exceed	TShs. 40 per 1,000, Tshs.5000/=
CHEQUE.	TShs. 100/=
ACKNOWLEDGEMENT of a debt: (a) of an amount not exceeding TShs. 1,000/= (b) of an amount exceeding TShs. 1,000/=	Nil TShs. 500/=
CERTIFICATE OR OTHER DOCUMENT evidencing the right or title of the holder, or any other person, either to any shares, scrip or stock in or of any incorporated company or other body corporate, or to become proprietor of shares, scrip or stock in or of any such company or body. See also Letter of Allotment of Shares	Tshs 500/=

CHARTER PARTY, that is to say, any instrument (except an agreement for the hire of a tug steamer) whereby a vessel or some specified principal part thereof is let for the specified purposes of the charterer whether it includes a penalty clause or not.	TShs.500/=
TRANSFER (whether with or without consideration) of shares in an incorporated company or other body corporate;	1 percent of the value of the shares approved by the Board
RECEIPT for any money or other property: (i) For an amount not exceeding TShs. 1,000/=. (ii) For an amount exceeding TShs. 1,000/=.	(i) Nil (ii) 1 percent
PARTNERSHIP: A. Instrument of: (i) Where the capital does not exceed TShs. 10,000/=. (ii) Where the capital exceeds TShs. 100,000/= but does not exceed TShs. 1,000,000/=. (iii) In any other case. B. Dissolution.	(i) TShs. 1,000/= (ii) TShs. 2,000/= (iii) TShs. 5,000/= TShs. 1,000
ADMINISTRATION BOND: (a) where the amount is less than TShs. 1,000/= (b) where the amount is TShs. 1,000/= or more	Nill Tshs 500