

2. CHAPTER TWO

2.0 THEORETICAL FRAMEWORK

2.1 THEORIES OF TAXATION

Among the theories of taxation are the theories for the Optimal Taxation of Capital Income and Financial Services,¹ The theory for General Sales Taxation,² The Theory of Public Finance (1959) based on The Ability-to-Pay Theory of Taxation,³ and the cost-of-service and benefit-of service. This research relies on the major and well-known Theory of Public Finance (1959) based on The Ability-to-Pay Theory of Taxation. The theory postulated by Richard Abel Musgrave⁴ in 1959.

This theory is highlighted because in Tanzania taxes are based on taxpayer's ability to pay from which taxes paid are seen as a sacrifice by taxpayers. Again under the Table 1.0, it is shown that, in Tanzania the indirect taxes play a dominant role than direct taxes. Example, from 2005-06 to 2012-13 the collection from indirect taxes was about twice the collection of direct taxes (Table 1.0).⁵

Also, it illustrates that, the total revenue including Local Government Authorities of Tanzania Mainland from the year 2010 to 2018 in Millions of Tanzanian Shilling are less than the total expenditure of Local Government Authorities for the years specified (Table 1.0).⁶ Hence, under economic recommendations, it is recommended that, there is a need for the country to change its policy by relying on direct taxes rather than relying on indirect

¹ TAXATION OF FINANCIAL INTERMEDIATION: THEORY AND PRACTICE FOR EMERGING ECONOMIES, The International Bank for Reconstruction and Development/The World Bank and Oxford university Press, New York, 31, 32, 33, 51-52, 59, 66-67, 70 (P. HONOHAN *et al* eds., 2003).

² R.F. Van Brederode, SYSTEMS OF GENERAL SALES TAXATION: THEORY, POLICY AND PRACTICE –SERIES ON INTERNATIONAL TAXATION, Wolters Kluwer Law International: Series on International Taxation, the Netherland, VOL. 33, 8-10 (2009).

³ M. Slade Kendrick, *the Ability-to-Pay Theory of Taxation*, 29 (1) THE AMERICAN ECONOMIC REVIEW 92-101, (March, 1939), available at http://www.jstor.org/stable/1806989?seq=1#page_scan_tab_contents (Last visited on February 22, 2017).

⁴ Richard Abel Musgrave (December 14, 1910 to January 15, 2007) was an American economist of German Heritage. His most cited work is The Theory of Public finance (1959), described as the first English language treatise in the field and a major contribution to public finance thought.

⁵ *Supra* note 7.

⁶ **Bank of Tanzania, ANNUAL REPORT 2017-18, (2017-18) available at <https://www.bot.go.tz/Publications/EconomicAndOperationsAnnualReports/BOT%20ANNUAL%20REPO RT%2017-18.pdf> (Last visited on January 15, 2019).**

taxes which is a relatively easy tax component to collect; the taxation which is somewhat painless to solve the fiscal needs regardless of their unjust effects on income distribution.⁷

The idea here is that, the Theory of Public Finance (1959) based on The Ability-to-Pay Theory of Taxation is the best taxation theory that has supported to achieve the specific objective of this research by enabling Tanzania. This is by examining and analysing the major and potential determinants of tax revenue collections for the core target of strengthening the domestic tax revenue performance and collections in Tanzania. So that, it should finance herself as far as recurrent and development expenditures instead of depending foreign finance like aids, loans and grants.

Example, through the mentioned recommendation which is in agreement with the alternative hypothesis number four where from the research findings, it has proved that, there is negative influence between the tax base (taxes on import and taxes on local goods and services) and the tax revenue in Tanzania (Table 10.0).

Hence, this research has relying on the Ability-to-Pay Theory of Taxation because it relying on sacrifice which is the progressive taxation emphasizing that, the high income earners must be taxed first before the lower and moderated income earners.⁸ However, their imposition should be equally or proportional to their income, that is, should not beyond their income capacity.⁹

In this regard, this theory is called the progressive taxation. This is because, it is linked with the theory of declining marginal utility of money and it eliminates the high incomes of the very rich via taxation.¹⁰ Doing that, the theory will enable solving the deficit problem

⁷ *Id.*

⁸ *Supra* note 313.

⁹ *Id.*

¹⁰ The theory of declining marginal utility of money implying the valid justification of the progressive taxation of rich people. The rich citizens/residents can earn as much as they like but they must invest their earnings in productive ways. If not, their wealth should be taxed and the amount thus collected be distributed among the have not for whom money has great utility in a day to day sense and in economic terms.

in Tanzania. Because the statistics has revealed that, the Tanzanian fiscal budget is running under deficit situation.¹¹

Specifically, under Table 30.0 Annexure VP, it is believed that, the expansionary financial or monetary policy by where the government have to reduce Required Reserves Ratio from commercial banks, lowering Discount Rate from the loans pursued by the banks, and finally buying more government bonds from the general public so as to release more funds to them for the enhancement of domestic Tanzanian economic activities (Table 30.0, Annexure VP).

Also, the theory through sacrifice will stimulate further collections of the local taxes in the country, since, it is revealed that, the local taxes imposed by Local Governments tax regime are considerably most significant in terms of economic, social and political impacts compared by the tax levied by the central government via Tanzania Revenue Authority and Zanzibar Revenue Board.¹²

Thus, based on Musgrave's Theory of Public Finance (1959), this research has used this theory to determine the potential determinants of tax revenue performance in Tanzania. It is based on the Ability-to-Pay approach. The Ability-to-Pay approach deals with the government revenue and expenditures transactions separately.¹³

Since in Tanzania taxes are based on taxpayer's ability to pay from which taxes paid are seen as a sacrifice by taxpayers. Hence, the earnings raise the issues of what the sacrifice of each taxpayer should be and how it should be measured to ensure equality of sacrifice among taxpayers. The concept of equal sacrifice is of three types: Equal sacrifice, Equal Proportional sacrifice and Equal Marginal sacrifice.¹⁴

¹¹ *Supra* note 316, at 224.

¹² O.H. Fjeldstad and J. Semboja, *Dilemmas of Fiscal Decentralisation: A Study of Local Government Taxation in Tanzania*, 27, 200(1) FORUM FOR DEVELOPMENT STUDIES, available at <http://www.tandfonline.com/doi/pdf/10.1080/08039410.2000.9666122?needAccess=true> (Last visited on February 17, 2017).

¹³ *Supra* note 313.

¹⁴ *Id.*

2.1.0 ASSUMPTIONS UNDERLYING THE ABILITY-TO-PAY THEORY OF TAXATION

There are three underlying assumptions that guide the theory, namely:

- a) As the supply of money increases, it's marginal utility declining.
- b) The sacrifice arising and exist because of the payment of taxes.
- c) That sacrifice can be expressed quantitatively.¹⁵

2.2 THE THEORY OF PUBLIC FINANCE (1959) BASED ON THE ABILITY-TO-PAY THEORY OF TAXATION

According to the M. Slade Kendrick, the Ability-to-Pay is the dominant theory of taxation which is usually interpreted in terms of sacrifice. The term sacrifice can be justified towards the progressive taxation due to the following three interpretations of the term: the equal-sacrifice theory, the equal-proportional, and the least-sacrifice theories.¹⁶

According to the equal-sacrifice theory, taxes should be laid in such a way that the sacrifices of all taxpayers are equal.¹⁷ The theory of equal-proportional sacrifice states that, the sacrifice of taxpayers should stand an equal proportion to their incomes.¹⁸ Thus, in this view equality of sacrifice is not sufficient. The rich man's tax payment should represent a greater sacrifice than the contribution of a man of moderate means.¹⁹ However, should not be greater in relation to his or her income.²⁰

Therefore, equality must be found in the proportion, rather than in the quantity of sacrifice.²¹ This means that, the three theories of progressive taxation have been raised and could be connected with the theory of declining marginal utility of money.²² Both the theories of equal-sacrifice and of equal-proportional sacrifice engage taxation of poor as well as rich persons.²³ Neither of the theory make any income group bear all the taxes.²⁴

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Supra* note 313, at 93.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Supra* note 320.

²³ *Supra* note 313, at 93.

²⁴ *Id.*

However, it is reported that, the two theories have the problem and weakness of distribution of the tax burden among individuals possessing varying incomes.²⁵ In this regard, the two theories have been classified as the individual theories.²⁶

On the other hand, the least-sacrifice theory obviously is a group theory of taxation in the sense that, it can be interpreted as the group theory of taxation.²⁷ This is because the objective of taxation is least sacrifice to the group. According to this theory, taxes should be charged first from the incomes of the very rich persons.²⁸

This implies that, persons of moderate means and incomes should be taxed only after the incomes of the very rich and the rich have been reduced by taxation to their capacity. In this regard, the theory is called the progressive taxation since it eliminates the high incomes of the very rich via taxation.²⁹

The major advantage of the above three theories is that, they have been derived from the common root age from the basic principle of the theory of declining marginal utility of money which stating that, the marginal utility of money declines with an increase in its supply.³⁰ But it is suggested by some theorist like Professor Pigou that, the utility of money must go down more sharply than the theory of declining utility requires if the objective of equal sacrifice lead to what known as progressive taxation.³¹ On the other hand, it implies that, the extent of declining of the utility of money with an increase in the supply could give a basis for progressive taxation under either, the theory of equal proportional sacrifice or that of least sacrifice.³²

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ A. C. Pigou, *A Study in Public Finance*, Macmillan, London, 1928. Professor Pigou's analysis of the general opinion respecting the relationship between the theory of marginal utility and progressive taxation is so effectively presented that, in all circumstances, in order to secure equal sacrifice, the tax formula must be in some measure progressive, in the sense that, the rate of taxation per Pound of income grows as incomes grow. This proposition is supposed to be logically deductible from the law of diminishing utility. That supposition is incorrect. All that the law of diminishing utility asserts is that the last Pound of 1,000 incomes carries less satisfaction than the last pound of a Pound of 100 incomes does.

³¹ *Id.*

³² *Id.*

According to the researcher, the Ability-to-Pay Theory of Taxation is based on the progressive taxation which can be justifiable on various grounds. The grounds are revolved from the broad reality of the economic system.³³ This means that, economic system considers that, taxes have both economic effects which ultimately lead to the social consequences.³⁴ Moreover, this can be interpreted that, the decision to choose type of taxes to impose and the rates to be applied expresses a preference to locate on economic effects, and hence social consequences to another.³⁵

However, there are many rivalry theories of taxation such as cost-of-service and benefit-of service³⁶ who's defected from inclusive principles, the theory of ability to pay has achieved to the status of predominant between theories of taxation. It is reported by the researcher that, is only the ability-to-pay theory which has reached the status of a general principle to which taxes and tax systems should be traditional obeyed and ruled.³⁷

According to the M. Slade Kendrick, the axiom "ability to pay" is superior, honest and it sound good.³⁸ Its meaning is that, money for public expenditures should be derived from "*him that hath*" instead of from "*him that hath not.*" This means that, the money for the sake of citizen's requirements should come from "him that have" rather than from "him that have not".³⁹

In this regard, it is argued that, no one can oppose that principle of the axiom or theory. Hence, it is reported that, that opinion has a great support now days since it became attractive even in the context of ethical associations.⁴⁰ According to the researcher, the actual meaning of the term ability to pay means much more than the levy of taxes on sources from which they can be paid.⁴¹ But, even in a sales tax paid by consumers on

³³ *Supra* note 313, at 93.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*, at 92.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

necessities of life could correspond to the ability to pay and can be interpreted in the revenue sense.⁴²

That is if every tax is becoming satisfied, most taxes would be levied according to ability to pay. In this regard, many examples of taxes that can be taxed based on the ability to pay approach are graduated income and inheritance taxes.⁴³ On the other hand, is only a poll tax, can be excluded to fall in the approach.⁴⁴

Moreover, the exactly meaning of the theory is falling in that ground of sacrifice.⁴⁵ This means that, the payment of a tax is viewed as a deprivation to the taxpayer. Example, instead of the consumer to spend his or her own money for self-concern, then he sacrifices the money to the public bank account from which they will be expended for social ends.⁴⁶ In this regard, the citizen's promise to pay their money to the government. Hence, in this sense, we are saying that, they are making a sacrifice. In this regard, it has been concluded that, sacrifice is the fundamental principle to which the levy of taxes should match, for that is the exactly meaning to the taxpayers.⁴⁷

In this regard, this study found that, out of the 100 percent tax stakeholders, the respondents 78.1 percent (53.7% strongly agreed plus 24.4% agreed) had agreed the argument that, the taxes paid "sacrificed" by Tanzanian citizens do impacts their social services like healthcare, education, and others; and that they do have relationship (Table 12.0, Annexure VC).

Similarly, this research has found that, among others factors or determinants that affecting tax revenue performance in Tanzania is the provision of public services by government. The others factors are laws and order, income inequality, tax exemptions, level of tax evasion and avoidance, budget rationalization, foreign debt stock, and foreign

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

debt (Table 22.0, Annexure VM). For more information about the factors refer Annexure II and III (pg. 19-21 & 17-19), respectively.

Hence, the citizens promise to pay their money to the government in return for the secured social services and goods from the same. Therefore, in order to stimulate the domestic tax revenue performance in the country, the government must commit this duty so as to build the strong confidence and willing to pay taxes to all Tanzanians citizens.

Upon attainment of the objective, the government of Tanzania in a fiscal year 2017-18 has sustained to align its expenditures with the available national resources, while observing the key priority programs in support of both poverty reduction and economic growth in the territory.⁴⁸ Example, construction of Stigler large gauge, free education in public schools from standard one up to secondary level, construction of infrastructures like roads, flyovers (Mfugale and the ongoing Ubungo flyovers)⁴⁹, construction of Tanzania Standard Gauge Railway⁵⁰, initiation of the Tanzania's new state-of-the-art terminal at the Julius Nyerere International Airport in Dar es Salaam⁵¹, etc.

Apart from income tax, VAT and others, it is recommended that, there is a need for Tanzania government to create the extra new reliable sources of tax base, creations of new wealth and the fiscal policy measures so as to generate more revenue (Table 12.0 Annexure VC; and Table 22.0 Annexure VM). Example, change in exchange rates, share of industrial sector, share of capital gains and profit, oil and mining sector, curbing of informal sector and underground economic activities, strengthening the service sector in G.D.P, secondary sector like manufacturing, reviewing and reducing the tax exemptions in the country, etc. (Table 12.0 Annexure VC; and Table 22.0 Annexure VM).

Likewise, under the suggestions of macro-economic policies in Tanzania, it is suggested that, it's highly advisable to strengthen or use our maximum available capacity "ability to pay" so as to fund or finance our own public expenditures rather than depending 40

⁴⁸ *Supra* note 15.

⁴⁹ *Supra* note 18.

⁵⁰ *Supra* note 20.

⁵¹ *Supra* note 19.

percent from the external finance like aid, loans, and grants.⁵² In the other words, the government must be accountable for the money it is receiving from the people's taxes. Doing so, the tax compliance in the nation would be succeeded.⁵³

Nonetheless, it is founded that, in order to stimulate voluntary tax compliance and attracting more private sectors, businesses and others tax stakeholders in keeping their duty of paying taxes based on their ability to pay in Tanzania. Also, Tanzania Revenue Authority and Zanzibar Revenue Board must be strengthened, examples in terms of customer cares, organizational structures, electronic capabilities, ensuring taxpayer's satisfactions, quality services, improving staff's skills and experiences, etc. (Table 18.0, Annexure VI).

Meanwhile, based from the theory, the real target of paying taxes for Tanzanians citizens is to get good and secured social services from their government. In this sense, it is suggested that, in order to attain the goal, the politicians must focus on the implementation of the nation's planned priorities rather than parties and self-interest for the purpose of avoiding fraud, corruption and embezzlement of public finance in Tanzania.⁵⁴

Once more, in order to increase the capacity of paying taxes among Tanzanians citizens, it is suggested that, the rising of our domestic production capacity must be prioritized so as to enhance more exports rather than importation of goods and services in the country. Further, it is suggested that, in order to increase the incentive and ability of the taxpayers in paying taxes, the government must ensure the presence of accountability and transparency after tax collections and development expenditures to the citizens. Also, bringing quality services to all citizens.⁵⁵

⁵² *Supra* note 252.

⁵³ *Supra* note 29, at V and IX.

⁵⁴ A.T. Kessy and W.Mc. Court, *Is Decentralization Still Recentralization? The Local Government Reform Programme in Tanzania*, 33(12-13) INTERNATIONAL JOURNAL OF PUBLIC ADMINISTRATION, available at <http://www.tandfonline.com/doi/full/10.1080/01900692.2010.514454?scroll=top&needAccess=true> (Last visited on February 18, 2017).

⁵⁵ Derived from the comments written in the questionnaire number 53 of ((M.O.F.P)-Ministry of Finance and Planning, Zanzibar) staff, about the appropriate measures, strategies or policies that can help to overcome

In addition to the exactly meaning of the theory that based on sacrifice, it was noted from Professor Seligman's view that *"A man's ability to pay taxes is to be measured not only by the relative burden imposed upon him in parting with his wealth, but also by the relative ease with which he has acquired his wealth."*⁵⁶ This means that, the money surrendered by the taxpayers should be modified by its relative easiness' from the means they were acquired.

2.3 THEORIES FOR THE OPTIMAL TAXATION OF CAPITAL INCOME AND FINANCIAL SERVICES

In this subsection, the idea is to present a broad for the wider discussion of financial intermediation by reviewing at least some central aspects of the theory. The central issue is whether capital income should be taxed or not? If it is to be taxed, then, at what rate and how, the services provided by financial intermediaries should be subject to commodity taxation.⁵⁷

On the other side, if it is not optimal to tax or subsidize capital income, then, the importance or rational for taxing the income associated with financial transactions it should become the practical idea to improve or strengthens the taxation of labour income or consumption.⁵⁸

This is among the pivotal concern and question being discussed about the taxing of financial activities. In this situation, the theory tries to address these questions more at particular at policy relevant with the regard to the concerns.⁵⁹ To answer the question on whether capital income should be taxed or not, and if it is to be taxed, at what rate and how the services provided by financial intermediaries should be subject to commodity taxation. Specifically, in Tanzania there is capital gain tax, with different tax rates for residents and non-residents, with type of the property, e.g., shares, land, building etc.

the challenges facing the tax revenue system in Zanzibar, the comment was on Section G(e) (Refer to Appendix III (pg. 21)), 2018.

⁵⁶ *Supra* note 313, at 93.

⁵⁷ *Supra* note 311, at 31 and 32.

⁵⁸ *Id.*

⁵⁹ *Id.*

The rates applicable for the tax are either 10% or 20%.⁶⁰ This is according to the Section 54(2) concerning stock exchange of the Income Tax Act 2014, from which at earlier it provided the incentives to withholding taxes but later they were removed.⁶¹ Based from the section, it is clearly shown that, the section has answered the question that, capital income in Tanzania is taxed and collected so as to funds public expenditures based on the rates mentioned above. Therefore, this findings have supported to achieve the specific objective of this research by enabling the country in utilising the suggestions and recommendations of the same.

The suggestions and recommendations will enhance the domestic tax revenue collections through manipulations of the analysed major and potential determinants of tax revenue performance of the research. Hence, the country will achieve the core target of strengthening the domestic tax revenue performance and collections in Tanzania. Eventually, it should finance herself as far as recurrent and development expenditures instead of depending foreign finance like aids, loans and grants.

2.3.0 THE OPTIMAL TAXATION OF CAPITAL INCOME

This theory focuses taxation on both taxing of capital income at household level and taxation of capital income at business level.

2.3.0.0 Assumptions

1) While government could commit to the future path of tax rates. It could also, ignore the fundamental time inconsistency problem that occurs during taxation of capital income. In this regard, it could also ignore a time consistency problem that is inbuilt to tax design in the presence of capital accumulation.⁶²

2) The government is unrestricted in its ability to issue debt. This is in effect uncouples the path of capital accumulation from private savings decisions. This means that, if private savings would imply too rapid an addition to the capital stock, the government can

⁶⁰ Sec. 54(2), The Income Tax Act, 2014.

⁶¹ Sec. 54(2), The Income Tax Act, 2014.

⁶² *Supra* note 311, at 32-33.

immerse up the excess by selling debt. If it implies excessive slow accumulation, the government itself can supply funds to finance investment.⁶³

2.3.0.1 The Optimal Taxation of Household Capital Income

The main concern of this sub section is on the optimality of taxing capital income or of not taxing it. To tackle this question depends on the type of model being used, the assumptions underlying the models and the information available to the government.⁶⁴

Another concerning issue is how to model dynamic economies, especially on how to cure bequest. This is because; the analysis is dynamic in nature, since capital income is generated from assets that by definition end for more than one period.⁶⁵ Regarding the optimality of taxing capital income, the Section 39 and Section 86 of The Income Tax Act 2014 have substantiated the optimality of taxing capital income in Tanzania.⁶⁶ Therefore, the sections have practically reported the best and most effective possible in taxing capital income in Tanzania.

Since the type of model being used in the country to collect tax revenue through capital income from assets is optimal to reinforce the domestic tax revenue performance and collections in Tanzania. In this analysis, the tremendous cases of relevance are the infinite lived dynastic model.⁶⁷ In this model, bequests are completely effective and agents are perfectly intuitive.⁶⁸ Another model is Overlapping Generations model where there are no bequests.⁶⁹

The main difference between these two cases is on the simplicity with which they can accommodate heterogeneous households.⁷⁰ On the side of the dynastic model, each cohort is naturally formulated as being a single representative agent; hence, the optimal tax problem adopts the classical Ramsey formulation.⁷¹ The Overlapping Generations

⁶³ *Id.*

⁶⁴ *Id.*, at 33.

⁶⁵ *Id.*

⁶⁶ Sec. 39 and Sec. 86, The Income Tax Act, 2014.

⁶⁷ *Supra* note 311, at 33.

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

model is better able to manage heterogeneity of the sort that is most relevant for introducing redistributive concerns.⁷²

To address these issues, the analysis has considered the appropriate role of capital income taxation in the three main cases. Firstly, on an economy consisting only one type of individual who lives for only two periods. Secondly, the Ramsey growth model of a single infinitely lived individual or dynasty and lastly, an Overlapping Generations model.⁷³

2.3.0.2 Optimal Taxation of Corporate Income

For taxing corporate income as part of an optimal tax system, there are two main types of arguments. The first one is classically stressed in policy discussion.⁷⁴ This argument is deeply analysed within the corporate tax as a withholding device against capital income at source. The second one is well analysed in the corporate tax as a tax on economic rents earned by corporations.⁷⁵

2.3.1 SUMMARY OF THE OPTIMAL TAXATION OF CAPITAL INCOME

The literature on the optimal taxation of capital income focused on the common question on whether capital income should be taxed at all or not. The answer to this question depends on what other models or instruments are accessible to the government.⁷⁶

Example, if the government is unhindered in its capacity to tax consumption and labour income.⁷⁷ In this scenario, the capital income tax is a redundant instrument.⁷⁸ This is because; its effects can be duplicated by introducing the appropriate time variation in these other taxes. Even when the capital income tax is not redundant in the case of choosing the instruments, there are important benchmark cases where it should not be used.⁷⁹

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*, at 51-52.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

For instance, in the case where the optimum happens to have the feature that, each individual consumption and labour supply remain fixed over time as in the case of balanced state of a Ramsey growth model, or in which intertemporal preferences have the feature that, there is no gain from distorting intertemporal prices. Undoubtedly, both of these are restrictive sets of circumstances.⁸⁰

Likewise, in the problem of time consistency, even when the government will decide not to tax capital income, it may be forced to do so due to the belief of private sector that, ex post, some of the such tax will be optimal.⁸¹ Then, the important attention is focused on the devices that can allow the government to alleviate this problem. The best example which proved to be fruitful in understanding why it is, that many developing countries prefer to offer tax holidays and other up-front concession or motivation to foreign investors.⁸²

In Tanzania for example, the government under mineral sector had provided number of tax holidays, tax exemptions and tax relief for the sole target of motivating foreign investors. For instance, the gold mining projects were exempted from corporate income tax, something that was not repealed until 2010 (International Centre for Tax and Development, 2012).⁸³

This means that, the investors in mining sector from 100 percent capital expensing and a 15 percent threshold on unredeemed qualifying capital expenditure.⁸⁴ This means that, even at a 15 percent rate of return, the investors still did not pay corporate taxes. For the time being, even V.A.T was characterized by multiple zero ratings. This means that, minerals were basically zero rated.⁸⁵

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Supra* note 136.

⁸⁴ *Id.*

⁸⁵ *Id.*

In addition, V.A.T on capital goods was initially deferred but later exempted. Apart from that, according to the report many of supplies of both goods and services to the mining investors were also benefited from tax relief. Thus, it is another form of zero rating in Tanzania.⁸⁶

All these tax holidays, tax exemptions and tax relieves contribute to the revenue loses to the side of the country. In this regard, under legal recommendations it is recommended that, the legal regimes in mining sector in Tanzania must be strengthened by eliminating numbers of the duties, taxes relief and exemptions in the country.

In conclusion, the act of charging income at the corporate level must be seen as a means to the end of taxing households, and to that extent is ultimately encouraged by administrative rather than theoretical concerns.⁸⁷ In this regard, there is potentiality an important role for the corporate tax as a means of withholding against personal capital income, and a corporate level tax may be a particular suitable way of taxing a non-distorting tax on rents.⁸⁸ Hence, this theory has helped us by providing quite clear guiding principle on how to proper tax design.⁸⁹

2.3.2 THE OPTIMAL TAXATION OF FINANCIAL SERVICES

There are many forms of financial services rendered by the financial companies. Example, the service of intermediating between borrowers and lenders, advice on financial arrangement, the risk pooling service of providing insurance, etc.⁹⁰ This means that, for the purchaser, they are fundamentally purchasing of commodity like any other commodity. For the side of the company, the sale of these services is a source of income to which the general tax principle applies.⁹¹

According to Table 31.0 Annexure VQ, this is connected to the others recommendations and suggestions where it is recommended that, among the appropriate measures,

⁸⁶ *Id.*

⁸⁷ *Supra* note 311, at 52.

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*, at 59.

⁹¹ *Id.*

strategies or policies that can help to overcome the challenges facing the tax revenue system in Tanzania is the provisions of the quality services to all citizens.⁹² Since, Tanzania also have number of financial services rendered by the financial companies from which the government generates revenues.

Example, insurance services, banking services like Automatic Telling Machine, consultancy services, etc. However, there is a need to strengthen these services so as to be most quality, affordable and reasonable to the general society for the same goal of government to generate more domestic revenue.

The important questions then arise as to how such purchases should be treated for tax purposes. How should the purchase of financial services be included into the wider indirect tax system? How can we identifying the price paid for financial services and how, in practice, such service can be taxed?⁹³

Sometimes financial markets are seen as being excessively volatile in the sense that, they adjust more rapidly than other markets. As a result, it is creating adjustment problems.⁹⁴ Categorically, for financial services provided on a fee-paying basis, such as safekeeping services, financial advice, the risk pooling service of providing insurance, the service of intermediating between borrowers and lenders, and many more. There is no tough difficulty. This means that, V.A.T or any other form of sales tax can be charged in the usual way.⁹⁵

The only difficulty arises for services charged for in the margin between the return paid to lenders and that charged to borrowers.⁹⁶ Accordingly, the problem is not only in identifying the total value added created by intermediation, but in allocating it between consumers to be taxed and producers not to be taxed. This is another big difficulty.⁹⁷

⁹² *Supra* note 365.

⁹³ *Supra* note 311, at 59.

⁹⁴ *Id.*, at 70.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.*

This difficulty has led most countries to use the invoice credit V.A.T.⁹⁸ This implies that, exemptions in financial intermediation was liable to all countries with V.A.T. This means, tax is not charged on outputs of the financial services sector, but no can tax paid on inputs be reclaimed.⁹⁹ In this regard, both consumers and businesses will bear some tax on their purchase of the financial sector. This is by the indirect form of unrecovered tax paid on the inputs such as software, office equipment etc. which used in their production.¹⁰⁰

For the case of Tanzania, VAT Act 2014 is not applicable to the share, however, the second schedule of the Act have a list of tax exemptions in financial intermediation in the country.¹⁰¹ In addition, there are tax exemptions in financial intermediation applicable in the country under Second schedule, Section 54 of Income Tax Act, 2014.¹⁰² This implies that, in Tanzania, the tax exemptions in financial intermediation is applicable to both V.A.T and to Income Tax Act in the land.

Some countries, example, Israel have instead taxed value added in financial services by the addition method.¹⁰³ These imply that, direct tax is charged wages and profits. Another alternative potential method is by the subtraction method, the way which proposed in Canada under which tax is simply levied on the surplus of a firm's outputs over its inputs.¹⁰⁴

For the side of Tanzania, the credit method is the VAT system used in the country where inputs and outputs are compared, ultimately, the customers will either pay or claim the tax.¹⁰⁵ Additionally, the system is also available and applicable based in consumption. Hence, the message is that, the VAT system of credit method used in Tanzania is applicable in consumption and sales, hence, not applicable to financial services.¹⁰⁶

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ Second Schedule, the Value Added Tax Act, 2014.

¹⁰² Sec. 54, Second Schedule, Income Tax Act, 2014.

¹⁰³ *Supra* note 311, at 66-67.

¹⁰⁴ *Id.*

¹⁰⁵ Email from W. Abdullahi, An Audit Manager, VA Business Assurance Services (Sisi Consultants Firm) Mbweni, Zanzibar to H.M. Nassor, researcher (February 13, 2020, 7:34 AM IST).

¹⁰⁶ *Id.*

On the other hand, in Tanzania, wages are under employment taxes and profit corporate tax, similarly as far as the system of United Kingdom is concerned.¹⁰⁷ From these findings, it is clearly seems that, the VAT system of credit method that used in Tanzania is quite similar to that of Canada (output-input), however, that of Tanzania is not subtraction method, but it is credit method.

Either method would in principle be absolutely adequate within a wider V.A.T system based widely on the subtraction or addition method.¹⁰⁸ Also, either method is capable of taxing total value added in this sector.¹⁰⁹ However, neither method, sits well with the application of the invoice credit method in the rest of V.A.T system.¹¹⁰ Moreover, neither one is enabling the detection of embodied V.A.T on a transaction by transaction basis.¹¹¹ Hence, neither one allows the systematic crediting of financial services provided to registered traders.¹¹²

Conclusively, these difficulties can be used to find a way around by applying V.A.T on a cash flow basis.¹¹³ Under this system, all inflows of funds including the receipt of a loan, and all interest receipts, would be treated of the same kind to sales, and be taxable if the recipient is registered.¹¹⁴ On the other hand, all the outflows including the payment of interest or repayment of loans would attract credit if the payer is registered.¹¹⁵

2.4 THEORY FOR GENERAL SALES TAXATION

This subsection lay down the theoretical foundation in which different types of sales taxes are categorized based on their coverage of the production and distribution chain and by analysing certain characteristics of consumption taxes.

¹⁰⁷ *Id.*

¹⁰⁸ *Supra* note 311, at 66-67.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

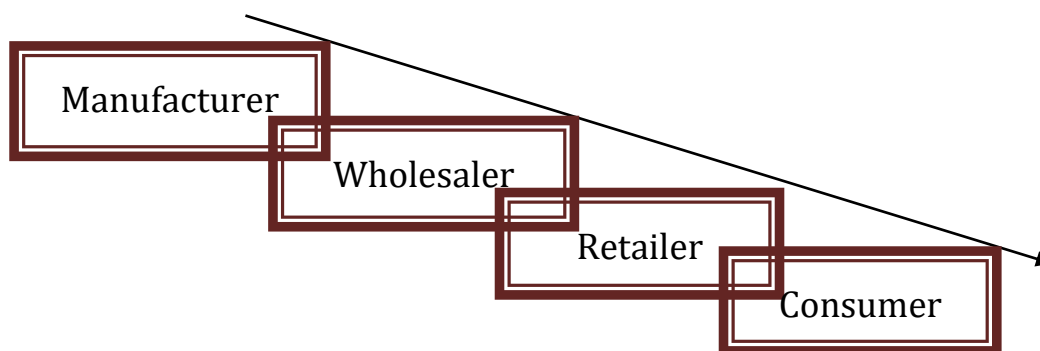
¹¹⁴ *Id.*

¹¹⁵ *Id.*

2.4.0 SYSTEMS OF SALES TAXATION

Literally it is important for policy makers to determine whether to levy a tax on a single stage of the production and distribution chain, on several stages or on all stages. Additionally, they would have to determine whether such a tax will be designed as a consumption tax or a business tax.

Figure 5.0¹¹⁶: Manufacturing and Distribution Chain



Source: (The book of R.F. Van Brederode, 2009).

Commonly, the difference is made between single stage, multiple stage and all stage taxes.

2.4.0.0 Single Stage Taxes

A single stage tax is imposed on only one of the stages of the manufacturing and distribution chain since it is levied on a single stage basis.¹¹⁷ Stage of the production and distribution chain at which the tax is applied is the basis for the classification.¹¹⁸ In effect, such kind of a tax will be manufacturing tax, a wholesaler tax or a retailer tax.¹¹⁹ Consider Figure 6.0¹²⁰ of single stage tax.

¹¹⁶ *Supra* note 312.

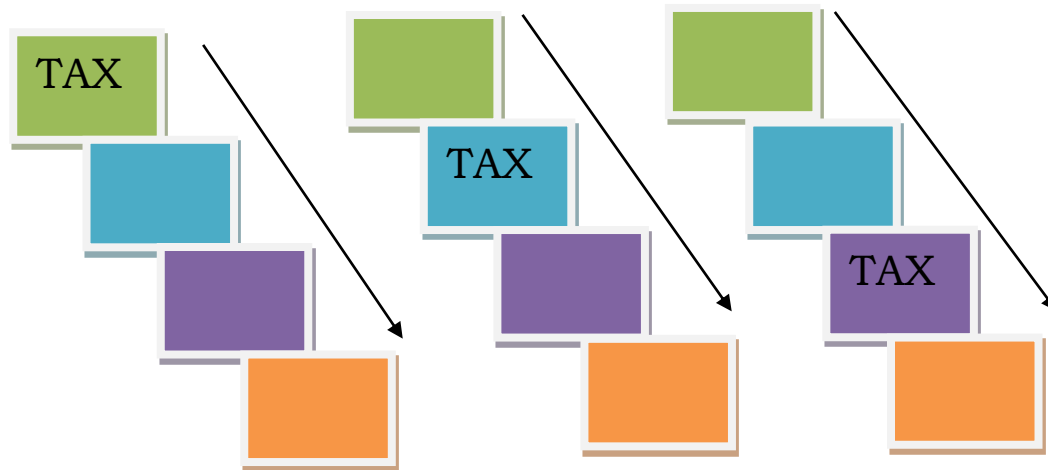
¹¹⁷ See John F. Due, *Sales Taxation* (London, 1957) for broad study.

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ R.F. Van Brederode (2009), *Single Stage Tax* (Figure 2) SYSTEMS OF GENERAL SALES TAXATION: THEORY, POLICY AND PRACTICE –SERIES ON INTERNATIONAL TAXATION, Wolters Kluwer Law International: Series on International Taxation, the Netherland, VOL. 33, 12 (2009).

Figure 6.0: Single Stage Tax



Source: (The book of R.F. Van Brederode, 2009).

1) Manufacturer Tax

A manufacturer's tax is normally practiced when the goods are sold by a manufacturer and not the wholesaler.¹²¹ The merit of this tax is that, the numbers of taxpayers are lower compared with wholesaler tax and retailer tax.¹²² Consequently, administration and collection costs and the risk of tax evasion will be reduced.¹²³

On another side, the demerits of the tax are such that, leads to the smaller the tax base, the higher the tax rates, occurrences of economic distortions, lead to economic inefficiencies, etc.¹²⁴ The reason of smaller the tax base and the higher the tax rates because of generating the same revenue in similar way to the later stages where there will be large numbers of taxpayers. Also, because the market value of a product increases as it progresses along the production and distribution chain.¹²⁵

The demerits of economic distortion may occur since; in reality the production of a certain good may incorporate several manufactures.¹²⁶ Thus, tax accumulation occurs, consequently creates an incentive to vertical integration plus cost forwarding beyond the

¹²¹ *Supra* note 312, at 12.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.*, at 12-13.

point of impact of the tax.¹²⁷ For instance, decision to allocate certain functions such as warranty and transportation are done at the wholesaler's stage so as to avoid tax in its value.¹²⁸

Since these decisions are made for the purpose of creating tax advantages only rather than by sound operational needs, this situation may lead to economic inefficiencies.¹²⁹ Therefore, economic distortion might occur depending on the stage of production and degree of integration at which the item becomes subject to tax.¹³⁰

The basic assumptions of the manufacture tax stage using production and distribution chain models are that, there is only single manufacturer, a single wholesaler and a single retailer.¹³¹ Also, the second assumption is that, in all situations of sells transactions from manufacturer via wholesaler and retailer to consumer, and that of direct sales from manufacturer to consumer with and without margin corrections, the tax is shifted forward to the final consumer.¹³²

However, the former assumption is far more complex. Also, on a frequent basis, manufacturer sells directly to consumers.¹³³ In this case he functions both as manufacturer and as retailer in relation to a particular commodity.¹³⁴

In this regard, in order to arrive at an equitable tax base and to ensure those identical goods are exposed to the same tax burden, it will be required to calculate the estimates both the wholesale and retail margins.¹³⁵ Thus, it must be subtracted from the price charged by the manufacturer to the consumer.¹³⁶

The best example, consider when manufacturer sells for 100 Tanzanian Shilling to the wholesale stage, which in turn sells for 125 Tanzanian Shilling to the retailer who in turn

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.*, at 13.

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*

sells for 175 Tanzanian Shilling to the consumer. In this case only 100 Tanzanian Shilling would be subject to the tax.¹³⁷

Sometime manufacturer may sell directly to consumers at the same price or a price close to the retailer price. In case of a direct sell to a consumer, the tax must be remitted by the manufacturer on the basis of 175 Tanzanian Shilling rather than of on 100 Tanzanian Shilling, unless corrections of margin are made.¹³⁸ Meanwhile, there are some distortions happening under a manufacturer's tax as a result of direct consumer sales.¹³⁹ However, the distortions could be reduced but never fully mitigated.¹⁴⁰

There are many factors determines the impact and size of such distortions. Example, height of statutory rate, the accuracy of the estimated margins, etc.¹⁴¹ The impact of distortion directly relates to the tax rate. This implies that, as the tax rate increase, the impact of the distortion would also be enhanced.¹⁴²

However, there are some counter measures could and have been designed to combat avoidance of such behaviour. The best examples are integration and forwarding function.¹⁴³ The measures have demerits that, increase in the complexity of the tax and subsequently of the cost of compliance and administration.¹⁴⁴

2) Wholesaler Tax

The tax under this stage of chain distribution is charged on the transaction before the goods reaches the final consumer.¹⁴⁵ However, wholesaler may sell goods either to the other wholesalers, or directly to consumers.¹⁴⁶

¹³⁷ *Id.*

¹³⁸ *Id.*, at 13-14.

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*, at 14.

¹⁴⁶ *Id.*

In this stage the number of taxpayers is greater compared to the previous stage of manufacturer's tax.¹⁴⁷ Hence, the tax rate is lower to generate the same revenue. However, their demerit is the increase in administrative and collection costs for tax authorities.¹⁴⁸

Another demerit is the similar one as previous manufacturer's stage where the degree of integration to a certain business will influence the effective tax rate bearer to the final consumer, which may lead to the distortions of competition.¹⁴⁹ The best countermeasure of this distortion is to consider the legislative countermeasures like that of imposition of internal sales.¹⁵⁰ However, these countermeasures complicate the tax since they lead to the costs of compliance for business, administrative as well as collection costs for the taxing institutions.¹⁵¹

In addition, the margins in this stage differ depending on the intended market segment as well as the type of product.¹⁵² Thus, correction of the sales price with the retail margin must be done through the statistical estimation since the wholesalers may sell goods directly to consumers.¹⁵³ The best example of the type of products are luxury goods which allow for higher margins than necessity goods.¹⁵⁴

Likewise, using a single retail margin would lead to a relatively lower tax on luxury goods than on these necessities, which normally solved through rate differentiation.¹⁵⁵ Nevertheless, the same commodity might be sold at different prices, hence, in different margins and dissimilar demographical areas because of price maximization.¹⁵⁶ In addition, there is a problem when luxury items are mixed with necessities, such that food items in a luxury gift box.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² See Ben Terra, Sales Taxation: The Case of Value Added Tax in the European Community, Series on International Taxation, no. 8 (Deventer-Boston: Kluwer, 1988), 23.

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ The best examples are electricity, gas and grocery prices may be difference among towns of diverse prosperity.

Also, there is a hindrance on a wholesale tax where complexities arise when the tax base is extended to services.¹⁵⁷ In this regard, services should be exempt at the wholesale stage unless they are provided to consumers. However, it's difficult for a services seller to determine in what capacity a buyer is buying a service.¹⁵⁸ For that reason, services are not included in or exempt from a wholesale tax. However, that makes this type of tax less desirable when the objective is to levy a general consumption tax.¹⁵⁹

3) Retail Tax

This tax is also known as a Retail Sales Tax is applied when the goods are sold to final consumers.¹⁶⁰ It includes all sales to the final consumers as well as those made by manufacturers and wholesalers.¹⁶¹

In this case, categorizations need to be made so as to make an administrative distinction between taxable consumer i.e. business to consumer sales and exempt business i.e. business to business sales.¹⁶² Normally this is done where tax authority offers certificates to business as a proof of their status.¹⁶³

For the case of Tanzania, the country tax system relies on taxation of goods, services and income from which the rates for V.A.T are 18 percent for standard rated supplies of taxable goods and services, and importation of taxable goods and services; and zero percent for exports of goods and services.¹⁶⁴ In this point, for tax collection increase, the research first finding is that, tax rate appears to have a strong long-run positive influence or relationship with tax revenue performance in Tanzanian economy.

That is, as tax rate increase by 1 percent, the tax revenue in Tanzania increases by 4.62 percent (Table 10.0). These results are in agreement with past empirical studies obtained

¹⁵⁷ *Supra* note 312, at 15.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ *Supra* note 4.

by M. Aamir *et al* (2011), E.K. Browning (March, 1989), Sangkyun Park (March, 1997), and W.F. Stine (July, 1988).

Hence, under policy recommendations and suggestions, it is suggested that, an ad-valorem rate of 18 percent for V.A.T should remain as it is and should not be increased. Since, the study's results had confirmed on the future rising of Tanzanian total tax revenue over G.D.P on the same rate (Table 10.0). This is because, V.A.T is one type of an indirect consumption tax, such that it is charged upon purchasing of commodities by final consumers.

In this regard, it will cost every one of the citizens if it will be increased, say from 18 percent to 20 percent, since it's regressive in nature.¹⁶⁵ Therefore, it is very good recommendation to remain as it is. Since, if it will be increased, it will add more inflation within the country, hence the rising of prices of goods and services will be reported in the land. Doing so, will enhance the domestic tax revenue collections and performance in Tanzania.

For the businesses who receive certificates for business sales, some problems might arise when a business certificate is used to for private uses and purchases.¹⁶⁶ Hence, the constant auditing of businesses on the basis of a risk analysis selection would be required to oppose this type of tax evasion, adding to the costs of administering the tax.¹⁶⁷

Moreover, when the certificates do not cover all business procurements, the tax would become part of the cost base of a business.¹⁶⁸ Hence, it would become part of a business tax, depending on a trader's ability to shift the tax burden forward. In addition, tax cascading also would occur; its size will depend on the length of the remainder of the chain and the stage at which the tax would be incurred.¹⁶⁹

¹⁶⁵ *Supra* note 148.

¹⁶⁶ *Supra* note 312, at 15.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

The advantages of Retail Sales Tax are that, there are large numbers of taxpayers who are answerable for its collection.¹⁷⁰ Hence, it allows for a relatively lower tax rate compared with a wholesale or manufacturer's tax to generate the same revenue. However, the large numbers of tax payers increasing the administrative cost for the tax authorities.¹⁷¹

One more problem in this trade is that, it is so difficult to apply for many small businesses engaged at this level.¹⁷² For this reason, policy makers may be reluctant to introduce the Retail Sales Tax or to include the retail level in like that of V.A.T. In this regard, it is highly advisable to design special provisions for small businesses than to exclude a complete stage from a V.A.T or to refrain from the introduction of the Retail Sales Tax.¹⁷³

Also, it has been said that, services should be included in general consumption tax.¹⁷⁴ However, this would present complex problems in a retail tax system.¹⁷⁵ Thus, only services to consumers have to subject to the tax, but there must be the distinction between the consumers and businesses.¹⁷⁶ This is because; services might be provided either for private or businesses purposes without the provider to identify the purposes.¹⁷⁷

The best example here is transportation services. In this example, a certificate system must be established so that, the burden can be minimized if an employee would take a taxi needed to carry a certificate for business travel, regarding that, a taxi driver also has no means of verifying whether its use is justified or not. Thus, for this reason, most states exclude services from the tax base.¹⁷⁸ However, the situation creates the environment of tax avoidance.¹⁷⁹ If the services with its value, is auxiliary to the supply of goods, then, it

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² *Id.*

¹⁷³ *Id.*

¹⁷⁴ *Id.*, at 15-16.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

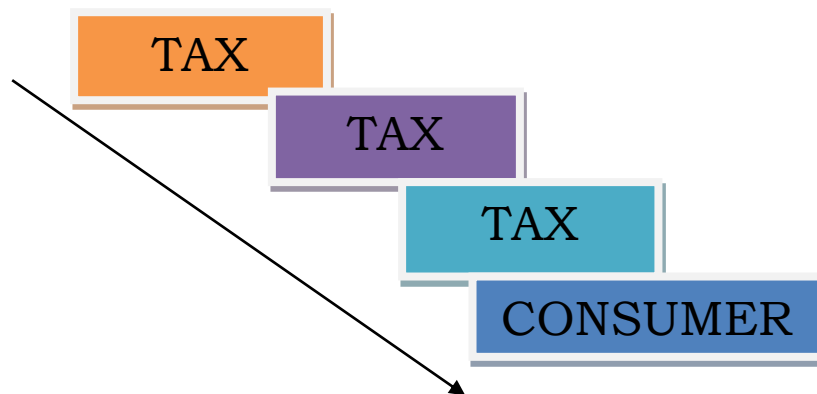
¹⁷⁹ *Id.*

is included in the overall taxable price, tax can be avoided by dividing activities in a non-taxable service and a taxable supply of goods, reducing the overall tax costs.¹⁸⁰

2.4.0.1 All Stage Taxes

In all stage taxes, tax is imposed on each and every stage of the chain while on a multiple stage tax, levies the tax on two or more stages of the manufacturing and distribution chain.¹⁸¹ Consider Figure 7.0¹⁸² of all stage tax.

Figure 7.0: All Stage Tax.



Source: (The book of R.F. Van Brederode, 2009).

In this stage dissimilarity is made between cumulative and non-cumulative all stage taxes.¹⁸³ This is because the tax could be charged at a single rate for all stages or at different rates to be applied for each stage or for some stages. The tax is payable on the total sale price charged to the customer.¹⁸⁴

In addition, tax cascading happening when taxes as aspects of the cost price for goods and services supplied to a business are absorbed in the business' selling prices and,

¹⁸⁰ The best reference in this respect by Terra, *Sales Taxation*, where Denmark and Norway applied a retail sales tax. Thus, to avoid the tax, they made the lists of taxable services. However, the system was very much complex which forced them to switch to a (V.A.T), Denmark is the best example.

¹⁸¹ *Supra* note 312.

¹⁸² R.F. Van Brederode (2009), *All Stage Tax* (Figure 3) SYSTEMS OF GENERAL SALES TAXATION: THEORY, POLICY AND PRACTICE –SERIES ON INTERNATIONAL TAXATION, Wolters Kluwer Law International: Series on International Taxation, the Netherland, VOL. 33, 16 (2009).

¹⁸³ *Supra* note 312, at 17.

¹⁸⁴ *Id.*

thus, are shifted to its customer.¹⁸⁵ However, it has an effect where an amount of tax paid at a previous stage is again subject to the tax at the following stage.¹⁸⁶ Therefore, the same amount of tax may be levied at multiple times in the course of production and distribution. Consequently, tax on tax effect is created where its magnitude is determined by the length of the chain of transactions.¹⁸⁷

There are many factors that hinder the difficulty in measuring the cascading. Example, supplier's market position, price elasticity of the goods or services,¹⁸⁸ etc. Meanwhile, the cascading effect has the tendency to differ from place to place and from company to company.¹⁸⁹ Also, it depends on the category of the goods whether tax changing occurs and to what extent is subject to question.¹⁹⁰

However, according to the Australian school of economic thought, all taxes are ultimately beard by businesses since no opportunity for shifting taxes forward due to price maximization.¹⁹¹ That is, all prices are determined by the interaction of supply and demand schedule for that particular kind of goods.¹⁹² Thus, if a sales tax is introduced, no room for businesses to raise prices so as to cover the additional tax cost. This is because; at all times, prices will be located at the maximum net revenue point for each seller.¹⁹³

In the other words, when tax is imposed, for each firm, prices are already at their highest net income levels.¹⁹⁴ In this regard, any addition to cost must be absorbed by the firm. For this reason, along the supply chain, it cannot be passed forward to the consumers.¹⁹⁵

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ *Id.*

¹⁸⁸ It is percentage decrease in demand for goods or services caused by percentage increase in their price.

¹⁸⁹ *Supra* note 312, at 17.

¹⁹⁰ *Id.*

¹⁹¹ See, Murray N. Rothbard, *Power and Market: Government and the Economy*, 2nd ed. (Kansas City, 1977), 88-93; Harry Gunnison Brown, "The Incidence of a General Sales Tax," in *Readings in the Economics of Taxation*, eds. Richard A. Musgrave & Carl S. Shoup (Homewood, IL, 1959), 330-330; Murray N. Rothard, "The Consumption Tax: A Critique," *Review of Austrian Economics* 7 (1994): 75-90.s

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

Hence, tax is not shifted forward but backward to either or both the labour factors and capital.¹⁹⁶

Besides, an important assumption of consumption taxes to be kept in mind is that, the tax is fully shifted forward along the manufacturing and distribution chain to the final consumer.¹⁹⁷ Meanwhile, tax accumulation leads to distortion of competition.¹⁹⁸ That is, as the length of the distribution chain increase, the tax burden increases. This means that, the shorter the chain the lower is the tax and vice versa is true.¹⁹⁹

Therefore, tax cascading favours integrated businesses over non-integrated businesses or in sourcing over outsourcing.²⁰⁰ Likewise, the tax discriminates against capital intensive businesses over labour intensive businesses.²⁰¹ Hence, there are some countermeasures can be considered deliberately to combat the disadvantages of cumulative taxes.²⁰² Example, exemption for sales between manufacturers so as to reduce the overall tax burden, introduction of integration charges to discourage vertical integration, and application of lower rates for the wholesale sector in view of their small margins.²⁰³

However, it has been said that, border tax adjustments with a cascading system can never be correct.²⁰⁴ Example, the tax burden will vary with the extent of the production and distribution chain, which consequently will be dissimilar even for similar products.²⁰⁵

However, under a tax system that applies the destination principle, an export product should leave the country of production free of tax, and an equalization tax must be levied in the country of destination so as to create a level of playing field with domestically produced goods.²⁰⁶ Also, under a cumulative tax system export rebates and import levies

¹⁹⁶ *Id.*

¹⁹⁷ *Supra* note 312, at 17.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ *Id.*, at 18.

²⁰¹ *Id.*

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ *Id.*

²⁰⁶ *Id.*

can only be based on estimates, which bear the risk of economic distortion when these estimates are accidentally or deliberately set to high.²⁰⁷

Thus, higher rebates effect in export subsidies and grant a price advantage for exported goods. On the other hand, higher import charges ensure market protection for domestic products competing with the imports.²⁰⁸

In addition, it has been contended by economist that, if cumulative tax systems applied at relatively lower rates, without significant distortion, the systems absolutely could be effective.²⁰⁹ Even so, noncumulative taxes, apply a methodology of determining the tax liability of a business that provides a discount for tax paid in previous stages of production and distribution chain.²¹⁰ However, the disadvantages of tax cascading or tax pyramiding are avoided in these taxes.²¹¹ In addition, they allow exact boarder tax adjustments that explain why they are preferred by economists and policy makers.²¹²

2.4.0.1.0 Gross Receipt Taxes

A Gross Receipt Taxes is a tax which is levied on total sales or outputs or turnover of a business without any credit or deduction for tax incurred on procurement.²¹³ It is the most frequently cumulative tax system applies in both past and in the present.²¹⁴ The tax is shifted forward, and accumulation occurs.²¹⁵ However, it is also associated with all the disadvantages of cumulative taxes outline above.²¹⁶

Consider example of a car manufacturer to see how tax can pyramid when many functions are outsourced.²¹⁷ Since, a car manufacturer uses many parts and components produced by other manufacturers who, in turn buy them from other specialized producers.

²⁰⁷ *Id.*

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ *Id.*

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ *Id.*

²¹⁷ *Id.*, at 19.

Moreover, they also incur costs of accounting and auditing, advertisement, etc.²¹⁸ Consider that all these sales are liable to a Gross Receipt Taxes, to be shifted forward.²¹⁹ In this regard, a potentially large sum of tax will be accumulated at the car manufacturers' level to be subsequently shifted forward to the dealer and then to the consumer.²²⁰

It has been said that, the more functions are outsourced, the more the tax will be accumulated eventually in the end price of the product.²²¹ In this situation, if the manufacturer's want to reduce the total tax burden of outsource functions, they have to include all or several of the outsourced functions within the company i.e. in sourcing.²²² This process is generally referred to as vertical integration and it is the source of serious economic disadvantages.²²³

2.4.0.1.1 V.A.T

Value added is the value where a businesses or producers add to their purchases or raw materials other than labour, prior to selling the thus-improved products or services.²²⁴ Most countries practiced sales tax systems that are levied at all stages of production and distribution chain without the tax accumulation effect.²²⁵

The systems can only be utilized by taking into account at each stage following to the first the tax paid at an earlier stage.²²⁶ Hence, taxing only the value added since the previous stage by each individual business. All these are because tax accumulation or tax pyramiding is superficial believed to have a detrimental economic effect that disturbs economic neutrality between businesses.²²⁷

For the case of Tanzania, as notified above, the country tax system relies on taxation of goods, services and income. The rates for V.A.T are 18 percent for standard rated

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ *Id.*

²²² *Id.*

²²³ *Id.*

²²⁴ *Id.* at 20.

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ *Id.* at 20.

supplies of taxable goods and services, and importation of taxable goods and services; and zero percent for exports of goods and services.²²⁸

Therefore, regarding this rate i.e. 18 percent, it is recommended that, it should not be increased. This is because, V.A.T is one type of an indirect consumption tax, such that it is charged upon purchasing of commodities by final consumers. In this regard, it will cost every one of the citizens if it will be increased, say from 18 percent to 20 percent, since it's regressive in nature.²²⁹ Therefore, it is very good recommendation to remain as it is. Since, if it will be increased, it will add more inflation within the country, hence the rising of prices of goods and services will be reported in the land.

Because of detrimental economic effect that disturbs economic neutrality between businesses, then, the important question then arising on which best approach or methodology to determine the value added of a particular business.²³⁰ Basically, there are three principal approaches are used towards the determination.²³¹

Addition Method is the first method, which intends to tax the total of all elements that make up value added. Subtraction Method is the second one whereby value added is determined by deducting total procurement costs from total turnover. This means that, it intends to taxes the differences between total outputs minus total inputs. Finally, the third method is Tax Credit Method which deducts the tax paid on procurement costs from the tax due on total sales. It is also known as tax from tax method.²³²

1) Addition Method

The Addition Method taxes all elements of the turnover of a business since they do not have been taxed from the previous stages of distribution chain.²³³ In this method the value added of a business is determined by adding up several things like its profits, wages which include employer's social insurance tax, and income in the form of government

²²⁸ *Supra* note 4.

²²⁹ *Supra* note 148.

²³⁰ *Supra* note 312, at 20.

²³¹ *Id.*

²³² *Id.*

²³³ *Id.*, at 20-21.

subsidies, interest and royalties, then multiplying the total with the statutory tax rate.²³⁴ The best example of the country applying the method is Israel which utilizing an Addition Method V.A.T in the financial sector.²³⁵ From 1976 through 2007, the SBT has been applied in the state of Michigan as a modified addition V.A.T.²³⁶

A method diverged from the standard form in which it provided for an apportioned formula, incorporating combination of origin and destination principles, and allocating one third of the tax base to the place of production and two thirds to the place of sale.²³⁷ Consequently, the competitive advantage of being taxed at the small tax rate liable to the imported goods rather than domestically produced goods.²³⁸

Another example is the New Hampshire Business Enterprise Tax which levied an addition V.A.T on businesses with revenue beyond a certain threshold.²³⁹ In this regard, a tax base is apportioned to New Hampshire on the basis of a three-factor formula.²⁴⁰ Meanwhile, the Business Enterprise Tax charge can be credited against a businesses' liability under the state's business profits tax.²⁴¹ The disadvantages of this method are that, it cannot accommodate multiple rates since companies cannot divide inputs by differential tax liabilities and their accounts do not distinguish different product categories within their sales that match with different sales tax rates.²⁴²

2) Subtraction Method

To compute the value added, the subtraction method, is an accounts-based method that relies on aggregative data over a fixed period of time usually one year.²⁴³ The V.A.T in subtraction method allows certain deduction and it is levied on gross receipts of a business.²⁴⁴ Thus, total purchases in a certain tax period are deducted from total sales in

²³⁴ *Id.*

²³⁵ See Oliver Oldman & Alan Schenk, *Value Added Tax: A Comparative Approach* (New York: Cambridge University Press, 2007), 328.

²³⁶ *Supra* note 312, at 20-21.

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ *Id.*

²⁴² *Id.*, at 21.

²⁴³ *Id.*

²⁴⁴ *Id.*

that same period of time to arrive at the value added generated by the business.²⁴⁵ The tax liability is computed by multiplying the value added with the statutory tax rate, or t (output–input).²⁴⁶

Generally, business gross receipts neither include proceeds from the sale of bonds, notes, or any other similar assets nor interest or similar income. Moreover, while interest payments and wages are non-deductible, inputs are deductible and expensed against taxable income. Also, capital goods are not subject to depreciation rules.²⁴⁷ The disadvantages of this method are that, it cannot hold multiples rates.²⁴⁸ Also, there is severe doubt whether boarder tax adjustments of a subtraction V.A.T are acceptable under World Trade Organization rules or not. The existence of this serious uncertainty is because the method is close resemblance to an income tax.²⁴⁹

3) Tax Credit Method

This method of tax credit has the advantage of accommodating the multiples rates of consumption tax.²⁵⁰ This is because; the method is capable of computing the tax on a transaction by transaction basis.²⁵¹ Also, according to the principle, each transaction is subject to the tax. Thus, a business will incur tax on its purchases and will charge tax on its sales.²⁵²

In addition, according to statutory reporting period, a business will figure out its tax liability by deducting the total amount of tax paid on procurement in the period from the total amount of tax charged on its sales in the period.²⁵³ The statutory reporting period can either be a calendar month, quarter or calendar year depending on the level of total gross turnover or the estimated total tax due.²⁵⁴

²⁴⁵ *Id.*

²⁴⁶ *Id.*

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ *Id.*

²⁵¹ *Id.*

²⁵² *Id.*

²⁵³ *Id.*

²⁵⁴ *Id.*

As notified, the best approach or methodology applicable to determine the value added V.A.T of a particular business in Tanzania is the tax credit method where inputs and outputs are compared.²⁵⁵ Finally, the customers will either pay or claim the tax.²⁵⁶ Additionally, the system is also available and applicable based in consumption. In this regard, the VAT system of credit method used in Tanzania is applicable in consumption and sales, and not applicable to financial services.²⁵⁷ On the other hand, in Tanzania, wages are under employment taxes and profit corporate tax, similarly as far as the system of United Kingdom.²⁵⁸

Based from these findings, it is clearly seems that, the VAT system of credit method that used in Tanzania is quite similar to that of Canada (output-input). However, that of Tanzania is not subtraction method, but it is tax credit method. Hence, the method is the appropriate one for the country.

²⁵⁵ *Supra* note 415.

²⁵⁶ *Id.*

²⁵⁷ *Id.*

²⁵⁸ *Id.*