

## **Presumptive Tax System and its Influence on the Ways Informal Entrepreneurs Behave in Tanzania**

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### **Abstract**

*The paper provides an analysis of how the presumptive tax system in Tanzania influenced the ways in which informal entrepreneurs behave. The established presumptive income tax system is based on solid sector and fiscal policies, and effective legal and institutional systems. Whereas the absolute increases in presumptive tax revenues and SME behaviour changes have partly been contributed by improvement of the presumptive scheme system, the study suggests that overall government reforms, tax surveys and patrols, tax severance and tax audits: all have their contributions to these achievements. However, the relative contribution of presumptive tax to total tax has been low and insignificant despite the presumptive tax reforms. Many SME firms are still outside the TRA tax net, suggesting the existence of weaknesses in the existing presumptive tax system. There is a need to intensify effective presumptive taxation reforms for SME entrepreneurs through rationalizing turnover tax regime, monitoring and controlling factors influencing behavioural patterns of SMEs, promoting segments focused on education and service to drive voluntary compliance, and improving operational efficiency.*

**Keywords:** SMEs, presumptive tax system in Tanzania

**JEL Codes:** H25, H26 and L26

### **1. Introduction**

Tanzania has significantly improved domestic revenue mobilization during the last eight years (TRA, 2011; Semboja, 2015). The tax revenue as percent of total GDP increased from 15.3 percent in the year 2008/2009, to about 18.5 percent in the year 2014/2015. This increased hand in hand with the increasing of presumptive income taxes during the same sample period.

Like many Sub-Saharan African countries, relative efficiency of tax collection in Tanzania has improved. Both presumptive income taxes for individuals with accounts and individuals with no accounts have been increasing during the last eight years. The total number income tax payers have been increasing faster than the number of presumptive income tax payers. This suggests that much as these efforts of presumptive scheme, (PS) have been undertaken to simplifying tax regimes, their outcomes have not been significant in pulling the informal and semi-informal sector operators into formal and, hence, bringing them in the TRA tax net. However, while presumptive income taxes for the first category has been high suggesting that TRA has instituted tax incentives to encourage firms preparing and keeping formal accounts, it is true for the second category that the presumptive tax system has not been very effective and significant enough to change the behaviour of the informal sector.

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The total presumptive income tax in Tanzania has been very small (about 0.4 percent during the period of 2008/9-2014/15) compared with other forms of income taxes, number of taxable entities and desired tax transformation targets. Clearly, the short-term effect of taxing small and medium scale enterprises is the possibility of increased revenue for fiscal expenditures. The medium and long-term effects are that by legitimizing more private enterprises, the country can provide greater access to business/vocational education and skills training for these small and medium scale firm's workers and micro business owners.

For many micro and small entrepreneurs in developing economies, the choice to pay tax or remain in the informal sector is a socio-economic complex decision. Most firms will choose to stay in the non-tax paying informal sector by default since the perceived short-term and temporary benefits outweigh the perceived immediate costs (Joel & Shlomo, 1994; Ofori, 2009; Marti, 2010; Nakiwala, 2010). If compliance costs—both financial and time—are added into a firm's cost-benefit analysis of paying taxes, the disincentive to comply with tax requirements becomes even stronger. On local government authorities, too, there is also a strong disincentive to collect taxes from small businesses. This is because the cost of monitoring, controlling and collecting taxes from informal micro and small businesses usually outweighs the revenues generated by micro and small businesses whilst revenue authority resources are still scarce.

## **2. Paper Objective**

The objective of the paper is to provide an analysis of how the tax system in Tanzania has influenced the ways in which informal sector entrepreneurs behave. The general socio-economic and political reforms pursued during the last ten years have improved the relationship between the business environment and taxation systems in Tanzania (UDSM, 2014). These reforms have necessitated small and medium scale entrepreneurs in the urban and major cities to join the tax net.

On the SME's side, participating in a tax regime brings a firm into the formal sector, and allows the firm to access formal credit markets, government procurement, and access to markets including export ones (Ofori, 2009; Marti, 2010; Nakiwala, 2010). On the government's side, by encouraging firms' behaviour of fully entering the formal sector through registering for and paying taxes, it promotes a culture of compliance and sets the stage for firms to grow and become bigger taxpayers. Additionally, firms in the formal sector are more likely to comply with all laws, regulations and official obligations than those in the informal sector (Coleman & Evans, 2003; TRA & UDSM, 2011).

## **3. Approach, Methods and Data Source**

The paper uses database from the research study by the UDSM-World Bank Study (2014). This study used four independent but complementary research methods and approaches (UDSM, 2014), namely: [i] desk study or literature reviews; [ii] field research survey; [iii] data, policy analysis reports; and [iv] internal TRA, MoF and TPSF consultative meetings.

The UDSM-World Bank presumptive tax study (2014) covered five years: from the financial year 2008/09 to 2012/13. It was a survey data for small and medium taxpayers, individuals and limited companies final assessments reserved in TRA database. Primary data was collected using questionnaires to respondents in seven (7) TRA regions. These seven regions contributed to about 80 percent of total taxes collected by TRA in the year 2012/2013. The survey covered about 662 small and medium scale firms.

Table 1.1 summarizes the presumptive tax survey coverage by region and type of sector. It shows that about 68.6 percent—i.e., a majority of surveyed potential tax paying small and medium scale (SME) firms—were in the trade sector; and a few—about 17.4 percent—were in the industry sector.

**Table 1: Presumptive Tax Survey Coverage by Region and by Type of Sector**

	Tax region					Total	%
	<i>Temeke</i>	<i>Kinondoni</i>	<i>Ilala</i>	<i>Mwanza</i>	<i>Manyara Mbeya</i>		
Agriculture	4	2	2	0	20	19	47 7.1
Industry	8	2	1	1	54	49	115 17.4
Service	31	8	3	4	0	0	46 6.9
Trade	84	86	109	155	8	12	454 68.6
<b>Total</b>	127	98	115	160	82	80	662
<b>Percent</b>	<b>19.2</b>	<b>14.8</b>	<b>17.4</b>	<b>24.2</b>	<b>12.4</b>	<b>19.2</b>	<b>14.8 100</b>

Source: Survey on poverty and social impact analysis of proposed presumptive tax in Tanzania (2014).

#### 4. Presumptive Income Tax System in Tanzania

This section presents the presumptive income tax system consisting of the policy environment (P), the legal framework (L), and the institutional framework (I).

##### 4.1 Policy Environment Presumptive Income Tax

The current Tanzanian presumptive income tax is rationalized and/or based on a solid sector and fiscal policies foundations (UDSM-TRA-2010). The rationalization of presumptive scheme has been in line with the National Small and Medium Enterprise Sector Policy of 2003. The policy has the objectives of enhancing business registration and simplifying the tax system. In specific, the national SME's policy of 2003, MKUKUTA II and annual budgets seek to simplify tax system and introduce tax incentives to nurse SMEs. According to URT (2003, 2012, 2013 and 2014), the policy objectives of presumptive tax scheme are to:

- (a) Rationalize turnover tax regime;
- (b) Increase administrative efficiency by minimizing real resources needed by TRA to administer income tax and stamp duty payable by small businesses separately;
- (c) Enhance compliance by minimizing time and trouble expended to fill in the relevant forms and up-and-down movements to TRA offices every month;
- (d) Eliminate avenues for evading taxes through submission of false sales declarations by taking advantage of sections 9 and 10 of the Stamp Duty Act, 1972;

- (e) Solve the problem of evading paying stamp duty by taxpayers once they pay income tax; and
- (f) Ensure that the simplified tax regime is applicable to small business taxpayers (SBTs).

Above all, the conventional objectives and expected impacts of presumptive income tax for small and medium scale firms target raising revenue for the government budget. Given that small and medium scale businesses generally do not generate substantial levels of income/consumption tax, TRA mostly devotes its minimal resources to large taxpayers. *Despite its limited institutional capacity, the presumptive income tax has a strong impact on a SME-firm's decision to enter the formal sector and thus grow* (Giampolo & Santoro, 2007; Ofori, 2009; Marti, 2010; Nakiwala, 2010). The achievement of institutional framework suggests a different type of tax administration system from a potential large taxpayer scheme to PS, and a slightly enhanced role for the revenue authority to include outreach and education, (URT, 2003, 2012, 2013 and 2014).

#### ***4.2 The Legal Framework of Presumptive Tax***

To attain the policy objectives of presumptive income tax, in July 2004 the government formalized the presumptive scheme by introducing a new simplified taxation schedule for small business taxpayers as part of a drive to make it easier for informal sector operators (including start-up businesses) to register, formalize and start paying taxes. The First Schedule of the Income Tax Act of 2004 (and amendments thereafter in 2006) defines and provides the content and structure of the current presumptive income tax in Tanzania. Section 1 defines tax rates to be charged to individual residents and non-residents, while Section 2 defines presumptive income tax based on turnover.

Where a resident individual meets the specific requirements under a year of income, the individual's income tax payable with respect to section 4(1)(a) for the year of income shall be equal to the amount of presumptive income tax provided for in subparagraph (3). It is stipulated that (a) an individual's income for a year of income consists exclusively of income from a business having a source in the United Republic; (b) the turnover of the business does not exceed the threshold in subparagraph (2); and (c) an individual does not elect to display this provision for the year of income. The current threshold referred to in subparagraph (1)(b) is TZS20m. There are two types of presumptive taxes under this act. The first type is tax payable where there are incomplete records and the second is taxable income where records are kept complete.

The presumptive income taxation, therefore, seemed to be a very appropriate method of tax administration for a specific relatively low income group of people earning less than TZS20m; especially those in semi-informal firms who do not keep records and do not qualify for VAT registration.

### **4.3 The Current Institutional Framework**

#### **4.3.1 Use of a Block Tax Management System**

At the institutional level, the presumptive income tax is administered, managed and operationalized by the Department of Domestic Revenue in the TRA. TRA is an established central body for the assessment and collection of specified revenue, to administer and enforce laws relating to such revenue, and to provide for related matters in the economy of Tanzania.

The TRA introduced, experimented and used specific institutional arrangement of the Block Management System (BMS) in order to have more taxpayers in the tax net, expand the tax base, and optimize tax revenue collection. The basic objectives of the new institutional arrangement was to promote compliance and register all eligible small and medium scale enterprises within a particular business, sectoral or geographical area through capturing their correct level of economic activities and gathering valuable tax information (Ofori, 2009; Marti, 2010; Nakiwala, 2010).

The BMS assists tax administration in improving and assuring the quality of assessments, as well as monitoring closely their business activities so as to be able to fight tax evasion. BMS has simplified the registration of traders, and brought non-filers and non-payers into the tax net through closer monitoring and collaboration with local government authorities. By reaching out to the unreached, the BMS is expected to widen the tax base.

The set-up of the BMS consists of areas of trading concentrations that are mapped up in small territories/segments, defined on the basis of geographical or administrative set-up, or a combination of a few streets to form a block. Each block is mandated to operate all the tax functions of registering, assessing, collecting and accounting for revenue collected. Each block is allocated staff to carry out those functions subject to rotation after a certain length of stay in one block. To measure performance, each block is allocated targets (including revenue collection targets) measured against set time-frames and benchmarks. To enable smooth functioning, each block has a leader who is answerable to an assistant manager, and assisted by a number of subordinates.

The advantages of the BMS are evident. As such, the Domestic Revenue Department (DRD) is currently working on modernization (automation) of the BMS by improving on the registration, coverage, information capturing and enforcement strategies. However, the survey on informal sector made by TRA-UDSM (2011) showed that the BMS is yet to be fully adopted as evidenced by the absence of records for registered presumptive traders for the years 2004 to 2010. Moreover, business entities in blocks are still being administered remotely from regional or district offices. Tax officers are not stationed in blocks as the operational system originally assumed.

#### **4.3.2 Leadership and Capacities**

To enhance presumptive income tax administration, the TRA is led by trained and skilled manpower in BMS. The BMS leadership and staff comprise of senior tax

officers (as heads of blocks), tax officers, assistant tax officers and tax assistants from compliance and enforcement sections. They are assigned with all duties and responsibilities relating to a respective block. These tax administrators are required to register all traders within a block, collect all the revenue and manage tax debts, and provide taxpayer services (TRA-UDSM, 2011). The desired human capacity, i.e., the required number of staff in a block, depends on the size of a block and the number of staff available in a region. They deal with all types of taxes in a block, and refer cases that require auditing to the Audit Department. The duration of stay by members of a block in a single block is two years, so that they rotate and work interchangeably for effective and efficient control of a block (ibid.).

A significant number of semi-formal SMEs interact with the tax offices where they are registered, many of which deal mainly with presumptive income taxes. The SMEs often deal with field desk officers or case officers who control virtually all of their engagement with the tax office (TRA-UDSM, 2011). In practice, the attempt to combine common and other overlapping functional activities under a single officer means concentration of power. Some of overlapping functions include registration, application forms and tax returns, taxpayer service programs, routine audit assignments, tax enforcement duties, and tax data processing and analysis. This may lead to improper procedural arrangements, weak internal controls, corrupt and arbitrary use of power, and conflict of interests (Terkper, 2003; Giampolo & Santoro, 2007).

The preoccupation with assessments may lead to a sharp decline in field inspections, even for formal SMEs taxpayers. Weak or unsuitable administration procedures impede SME compliance and presumptive income tax performance. There are views that the BMS has not been optimally utilized or effectively operationalized due to limited financial and human resources, corruption, willingness and the capacity of the TRA (Coleman & Evans, 2003; UDSM, 2014). This clearly shows the importance of formal specific tax laws, regulations and procedures in streamlining the TRA tax administration regimes, linking human resource development and effective use of manpower at the operational levels. That goal can be achieved by not generalizing the weaknesses of SMEs, especially those of small and medium entities with fixed locations in most urban areas.

## **5. Presumptive Income Tax Performances**

This section reviews performances of presumptive income system in terms of the number of taxable categories, advantages and disadvantages of presumptive tax system, revenue generation for the government budget, number of registered presumptive income tax payers, and presumptive income tax payers' trend.

### **5.1 Taxable Categories**

Before July 2005, SMEs with sales turnover of less than TZS20m per annum were paying two types of taxes to TRA: stamp duty on receipt, and presumptive income tax. By then these taxes were assessed on the basis of values of sales. To reduce costs of administering tax compliance for SME businesses, it was proposed in July 2005 to abolish stamp duty on receipts and increase presumptive income

tax rates to partly compensate the loss of resulting loss from the measure. In short, the two taxes were merged into one type of tax best known as turnover-based taxes. Also, the VAT threshold was increased from TZS20m to TZS40m, which caused some VAT registered taxpayers to drop from the VAT system and join the presumptive taxation system (TRA-UDSM, 2011). The resulting new annual rates of presumptive tax were also adjusted.

Table 2 shows two categories of taxpayers. The first category includes individual taxpayers who do not keep records for their businesses, and the second category includes those who keep complete records for their business transactions. In both cases, as mentioned earlier, the rates are applicable only if their business turnover is less than TZS20 million. Within these categories, the First Schedule introduces four bands or income level brackets.

**Table 2: The Presumptive Tax Rates**

**A. Previous System under Income Tax Act 2006 (Effective until June 2012)**

Turnover per Annum	Tax Payable (Incomplete or No Records)	Tax Payable (Records are Kept)
Where turnover does not exceed TZS3,000,000	TZS35,000	1.1% of the annual turnover
Where turnover is between TZS3,000,000 and TZS7,000,000	TZS95,000	TZS33,000 plus 1.3% of the turnover in excess of TZS3,000,000
Where turnover is between Sh. 7,000,000 and TZS14,000,000	TZS291,000	TZS85,000 plus 2.5% of the turnover in excess of TZS7,000,000
Where turnover is between TZS14,000,000 and TZS20,000,000	TZS520,000	TZS260,000 plus 3.3% of the turnover in excess of TZS14,000,000

**B. New System introduced by Finance Act 2012 (Effective from July 2012)**

Annual Turnover	Compliance with Section 80 of the Income Tax Act 2004	
	Not Complied	Complied
Where turnover does not exceed TZS4,000,000	NIL	NIL
Where turnover is between TZS4,000,000 and TZS7,500,000	TZS100,000	2.0% of the turnover in excess of TZS4,000,000
Where turnover is between TZS7,500,000 and TZS11,500,000	TZS212,000	TZS70,000 plus 2.5% of the turnover in excess of TZS7,500,000
Where turnover is between TZS11,500,000 and TZS16,000,000	TZS364,000	TZS175,000 plus 3.0% of the turnover in excess of TZS11,500,000
Where turnover is between TZS16,000,000 and TZS20,000,000	TZS575,000	TZS305,000 plus 3.5% of the turnover in excess of TZS16,000,000

**Notes:** (1) Where turnover exceeds TZS 20,000,000 p.a. the taxpayer is obliged to prepare audited financial statements in respect of his/her business.

(2) Any taxpayer with turnover of TZS 14,000,000 p.a. is obliged to acquire and use Electronic Fiscal Devices (EFDs) machine for his/her business transactions.

(3) It is also important to note that there has been a new schedule adopted under Finance Act 2014 – adopted after the data collection for this study was done.

The tax income Act introduced and integrated some aspects of informality. In many cases and in practise, SMEs are classified as semi-formal or informal on the basis of their potential ability to comply with administrative procedures. Some of these individual tax payers are not legally registered or licensed by other government authorities, but are accepted as semi-formal business entities and taxable in this system (TRA-UDSM, 2011).

The weak SME management and financial systems can make it easy for owners/managers of SMEs and associates to override the limited controls that may exist, leading to malfeasance such as suppression of transactions and falsification of accounting records (Terkper, 2003). The Act provides fiscal incentives to accommodate business informal book-keeping. Of course, there are those taxpayers falling in the first category and do keep complete records of their business transactions. Their informal bookkeeping records are accepted as official accounts, and therefore they enjoy all benefits by paying less presumptive income tax than business entities in the same income band as stipulated in the Income Tax Act 2004.

The TRA Act introduced elements of behavioural transformation from informal to formal business entities. That is, the Act has both bad and good fiscal incentives intended to support behavioural changes and the development of the informal/SME sector. Apart from reducing the tax burden to this segment of taxpayers, the measure will provide incentive for better record-keeping behaviour among small businesses (Ofori, 2009; Marti, 2010; Nakiwala, 2010). Furthermore, if satisfactory records of income and expenses are kept and produced to the TRA, taxpayers will file returns and be assessed on their profits rather than on turnover, which is preferable.

On the administration side, since small businesses are excluded from the tax regime, and small businesses that pay the presumptive tax are found to contribute very little to the overall tax collection, there has been a great attention on the need of the interaction of the TRA and the sector. However, the environment for doing business in the country has made it difficult to administer the presumptive income taxation scheme and/or help firms graduate to the standard tax regime. Moreover, the perceivable benefit of paying taxes by small businesses has had no incentive to make SMEs pay taxes at all.

In addition, it is difficult for small businesses to have a collective body to represent them given the diversity of operators of businesses and thus interests. Thus, there is no effective mechanism for small entrepreneurs to voice their tax concerns. This has made difficult to administer small businesses despite the current use of the BMS by the TRA.

Due to the nature and environment of businesses in the country, many small businesses tend to opt for the presumptive regime (Joel & Shlomo, 1994). Although this simplifies tax administration, it does not contribute to creating or



strengthening a culture of compliance among small businesses. Additionally, although small businesses are not required to register for VAT, staying out of the VAT net may be more of a tax burden to them than paying the tax. This behavioural burden is compounded by taxes and fees at municipal or district levels that tend to be very significant for small businesses. As much of the economy is made up of small businesses, most of which are informal, this study suggests that tax compliance behaviour and recording requirements are strong deterrents to formal registering of a business.

The presumptive tax system used in Tanzania is well known as a rationalized turnover based presumptive tax system. In this system different business segments may have substantially different turnover/net profit ratios. A rationalized system tends to maximize advantages and minimizes disadvantages of a presumptive tax system. Table 3 summarizes the advantages and disadvantages of the presumptive taxes system in Tanzania. To avoid major differences in the real (net) income tax burden, it is necessary to apply different tax rates on turnover according to the average profit ratio. The differentiation will have to be kept at a minimum, however, for reasons of simplicity, and to avoid tax evasion possibilities and disputes between taxpayers and tax administrators over the rates to apply (Allingham & Sandmo, 1972; Jaramillo, 2004). Typically, such an approach differentiates between traders and businesses in the service sector.

**Table 3: Presumptive Tax System: Advantages and Disadvantages**

Type of system	Tax base/ Indicator	Advantages	Disadvantages
Turnover based system	Business turnover	Guarantees minimum level of vertical and horizontal equity Easier transition from presumptive to standard regime as turnover is also a decisive element of tax calculation in standard systems. High revenue potential compared to other presumptive systems	High risk of turnover under declaration High risk of corruption System generally favours businesses with high profit margins

**Source:** Survey on poverty and social impact analysis of proposed presumptive tax in Tanzania (2014).

The approach tends to increase the fairness of the system but it is difficult to administer for small businesses carrying out both trade and service activities. Turnover-based presumptive tax system seems easy to design. It also reduces risks of disputes over the applicable tax rates, and do not require complicated comparisons of profit margins in different small business segments.

There is a substantial design challenge, however, when it comes to fixing the level of standard deduction from turnover/gross income, or the tax rates to be applied. An implicit feature of turnover-based systems is that it may result in a comparatively high tax burden for businesses with a comparatively low profit margin, and a relatively low tax burden for MSEs with very high profit margins (Jaramillo, 2004).

On one end of the spectrum such a situation forces MSEs to either opt out of the taxation system, bear the substantially higher compliance costs of the standard tax system, or to cease formal business activities (Plumley, 1996; Ačevska, 2002; Pope & Abdul-Jabbar, 2008). On the other end it creates a behaviour for businesses above the threshold to under-declare turnover or to split up in order to be able to move into the presumptive system, thus causing revenue losses to the Treasury.

A high tax rate on turnover quickly becomes prohibitive, as can be seen from the example of Cuba (TRA-UDSM, 2011). As the attractiveness of the simplified regime largely depends on the actual profit margin of a business, more sophisticated small taxpayers in high cost/turnover business sectors get an unintended incentive to move out of the system which can significantly change the mix of small taxpayer categories taxed on a presumptive basis (Pope & Abdul-Jabbar, 2008). Such behaviour has been made in Hungary with the application of a simplified entrepreneurial tax (TRA-UDSM, 2011). There is no general guideline for the determination of the tax rate in case of a turnover-based presumptive system. Extensive analysis into average MSE profit margins is required before setting the rate.

### ***5.2 Raising Revenue for the Government Budget***

Table 4 summarizes revenue performances of presumptive income tax in Tanzania for the period 2008/2009 to 2012/2013. In addition, it has a summary statistics of other tax performance indicators for behavioural change of SMEs in the taxation system. The table suggests that Tanzania has significantly improved domestic revenue mobilization. The tax revenue as percent of total GDP increased from 15.3 percent in year 2008/2009 to about 16.0 percent in year 2012/2013. This increased hand in hand with increasing of presumptive income taxes.

Table 4 also indicates that both presumptive income taxes for individuals with accounts and individuals without accounts were increasing during the sample period. It is interesting to note that while presumptive income taxes for the first category were high, suggesting that TRA has instituted tax incentives to encourage firms to prepare and keep formal accounts, it is true for the second category that the presumptive tax system has not been very effective and significant enough to change the behaviour of the informal sector (UDSM, 2014).

Table 4 further suggests that the total presumptive income tax has been very small compared with other forms of income taxes, the number of taxable entities and desired tax transformation targets. Clearly, the short-term effect of taxing small and medium scale enterprises is the possibility of increased revenue for fiscal expenditures. The medium and long-term effects are that by legitimizing more private enterprises, the country can provide greater access to business/vocational education and skills training for small and medium scale firms' workers and micro business owners (Machogu & Amayi, 2013). The improvement in human capital behaviour has far-reaching long-term macroeconomic effects with increases in productivity and improved national competitiveness.

Table 3.5A: Presumptive Income Tax Basic Statistics

	2008/09	2009/10	2010/11	2011/12	2012/13
Total TRA Net Collections	4,051,964	4,437,933	5,315,148	6,502,599	7,739,298
Total TRA Net Domestic Collections (excluding Customs & Excise)	2,280,240	2,480,223	2,969,746	3,871,177	4,747,921
GDP.mp (TZS m)	26,474,230	30,321,314	35,026,679	41,125,313	48,345,661
Individual (Account cases) tax revenue (Mil. TZS.)	31,197.9	34,813.4	41,774.9	46,664.0	49,275.4
Individual - Non Account Cases (Presumptive) tax revenue (TZS m)	10,911.8	13,818.6	16,628.0	19,104.4	20,633.6
Presumptive taxpayers	322,403	376,673	414,395	459,674	498,442
Total number of TRA taxpayers	487,983	617,877	845,737	1,035,281	1,197,814
% of presumptive taxpayers to total TRA taxpayers	66%	61%	49%	44%	42%
Growth rate of Presumptive Taxpayers	1.11	1.17	1.10	1.11	1.08
Growth rate of Total TRA Taxpayers	1.23	1.27	1.37	1.22	1.16
% of Presumptive to Total Individual Revenue Collections	25.9%	28.4%	28.5%	29.0%	29.5%
% of Individual (Account Cases) Revenue to GDP	0.12%	0.11%	0.12%	0.11%	0.10%
% of Presumptive Revenues to GDP	0.04%	0.05%	0.05%	0.05%	0.04%
% of Total Individual (Account & Non Account Case) Revenues to GDP	0.16%	0.16%	0.17%	0.16%	0.14%
% of Presumptive to Total TRA Taxpayers	66.1%	61.0%	49.0%	44.4%	41.6%
% of Total Individual (Account & Non Account Case) Revenues to Total TRA Net	1.04%	1.10%	1.10%	1.01%	0.90%
% of Presumptive Revenues to Total TRA Net	0.27%	0.31%	0.31%	0.29%	0.27%
% of Total Individual (Account & Non Account Case) Revenues to Total TRA Net Domestic	1.85%	1.96%	1.97%	1.70%	1.47%
% of Presumptive Revenues to Total TRA Net Domestic	0.48%	0.56%	0.56%	0.49%	0.43%

Source: TRA Database (2014)

As more informal enterprises enter the formal sector through legal registration and regulatory compliances, they will have greater access to business development services (BDS), and can work towards improved productivity and product quality. If they are able to produce output that is globally competitive, they will be able to expand their operations, increase employment opportunities, and contribute to domestic economic growth and thus government revenues.

An improvement in the legitimization of businesses due to the imposition of rational tax system and subsequent human capital training should lead to a reduction in the socio-economic crime rate in many urban areas (Ofori, 2009; Marti, 2010; Nakiwala, 2010).

### **5.3 Number of Registered Presumptive Income Tax Payers**

Table 4 shows that the quantity, i.e., the total number of registered tax payers increased from 487,983 in 2008/2009 to 1,197,814 in 2012/2013. Meanwhile, presumptive income tax payers increased from 322,403 in 2008/2009 to 498,442 in 2012/2013. However, the total number of presumptive income tax payers as a percent of total TRA taxpayers decreased from 66 percent in 2008/2009 to about 42 percent in 2012/13. Whereas some studies acknowledge the absolute increase to have partly been contributed by improvement of the presumptive scheme system, this study also feels that other tax administrative measures have largely contributed to this achievement (Plumley, 1996; UDSM, 2014). Block tax management system, tax survey and patrols, tax severance and tax audits surely have their contributions to this achievement.

TRA initially designed a presumptive scheme to apply only to small business individuals who did not maintain sets of business accounts, and it was decided to extend its application to similar small businesses keeping complete records as a mechanism to promote, formalize or induce the former to emulate the latter in keeping complete business records. The presumptive tax was designed to serve two functions. *Firstly*, it was designed to reach out to those not reachable through the formal personal income tax (PIT) and ensure equitable tax system. *Secondly*, it aimed to institute in-built attributes to motivate operators under the presumptive scheme to graduate into the preferred tax system. When the scheme was introduced in Tanzania, it was meant to cover all taxpayers not registered under the VAT scheme. In July 2004, a twin-reform was undertaken to revise VAT threshold from the annual turnover of TZS20m to TZS40m per annum, and merge the presumptive income tax scheme with the receipt-based stamp duty.

The proposal to raise the VAT threshold was not followed suit with an increase in maximum turnover to TZS40m under the presumptive turnover. This resulted into the application of two different schemes for income taxation applicable to businesses with turnover below the VAT registration threshold: namely, the presumptive income tax scheme for businesses with turnovers not exceeding TZS20m per annum; and the personal income tax scheme for businesses with turnover above TZS20m per annum but not exceeding TZS40m per annum.

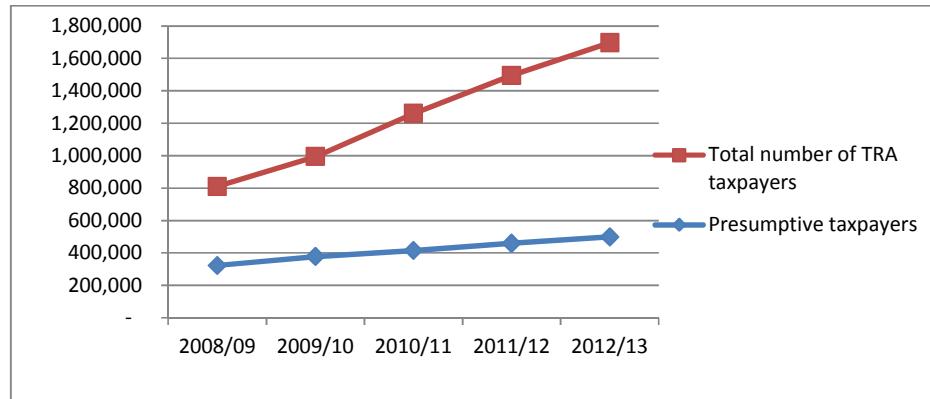
Consultations with key stakeholders suggest that the presumptive regime in Tanzania, while well-designed, still exhibits the following anomalies (UDSM, 2014):

- The system is regressive as non-record-keepers are more likely to lack the capacity to keep proper accounts.
- For 'non-record keepers', the system is not consistently progressive.
- The exit threshold for the presumptive regime of TZS20m is inconsistent with the VAT threshold of TZS40m.

### **5.4 Total and Presumptive Income Tax Payers Trend**

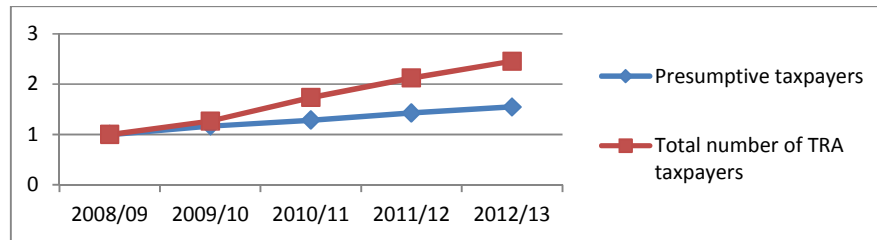
Figs 1 and 2 show the total of TRA taxpayers and presumptive income taxpayer's trend index from 2008/2009 to 2012/2013 both in absolute and relative figures

where we pegged year 2008/2009 as equal to 1. Fig. 2 shows that both the total numbers of TRA taxpayers and presumptive income taxpayers have been increasing during the last five years.



**Figure 1: A Total and Presumptive Income Tax Trend in Absolute Figures**

Source: TRA Database (2010)

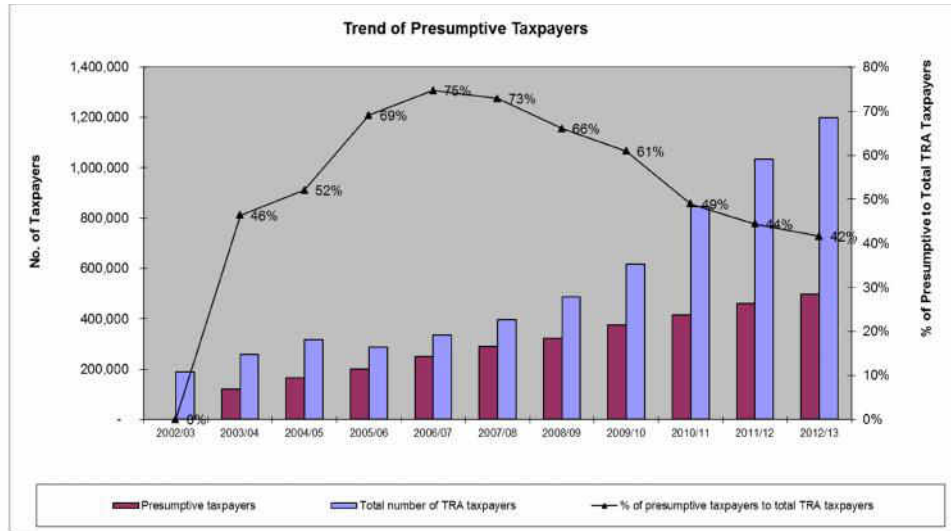


**Figure 2: Total and Presumptive Income Tax Payers Trend Index (2008/2009 = 1)**

Source: TRA Database as of 2010

However, Fig. 3 suggests that since 2007/2008 the number of total income taxpayers have been increasing faster than the number of presumptive income taxpayers. This suggests that much as the efforts of presumptive scheme have been undertaken to simplify the tax regimes, their outcomes have been significant in pulling the informal and semi-informal sector operators into the formal one, and hence bringing them in the TRA tax net. That is, after a lag of three to four years, the new system has been effective, and this needs to be enhanced.

Notwithstanding, the study suggests that an increasing number of the operators in the informal sector are still operating outside the TRA net due to lack of information, education and knowledge about tax system and its importance



**Figure 3: Trend of Presumptive Taxpayers against Total TRA Taxpayers**

Source: TRA Database 2014

(Machogu & Amayi, 2013; UDSM, 2014). Stakeholders are however concerned that the scheme is inconsistent with the P.A.Y.E (Equity considerations) whereby traders with small turnover are highly charged than those with higher turnover in the same band. They feel that the scheme should be harmonized with PAYE (to include the nil tax bands) and the threshold should be harmonized with increased VAT registration threshold.

**6. Analysis of the Current Presumptive Tax Structure**

**6.1 Structure of Tax Paid Under New Regime from 2012/13**

This section presents an analysis of the current presumptive tax structures. Fig. 4 shows presumptive tax structure under the current regime from 2012/13. The figure suggests that the current presumptive tax structure exhibits the characteristics of punishing those with lower turnover than those with higher turnover within each band.

Fig. 5 shows the relationship between tax paid and effective taxes which decreases as turnover increases. The relationship suggests that the current presumptive tax system penalizes lower turnovers. As can be seen in Fig. 5, the current structure does not obey the horizontal and vertical equity principle. Within each band, the effective tax rate of taxpayers with small turnover is higher than those with high turnover. The effective tax rate for taxpayers in the same tax band who have small turnover is higher than those with higher turnover within the same tax band as Fig. 5 shows. This implies that the presumptive tax may be regressive.

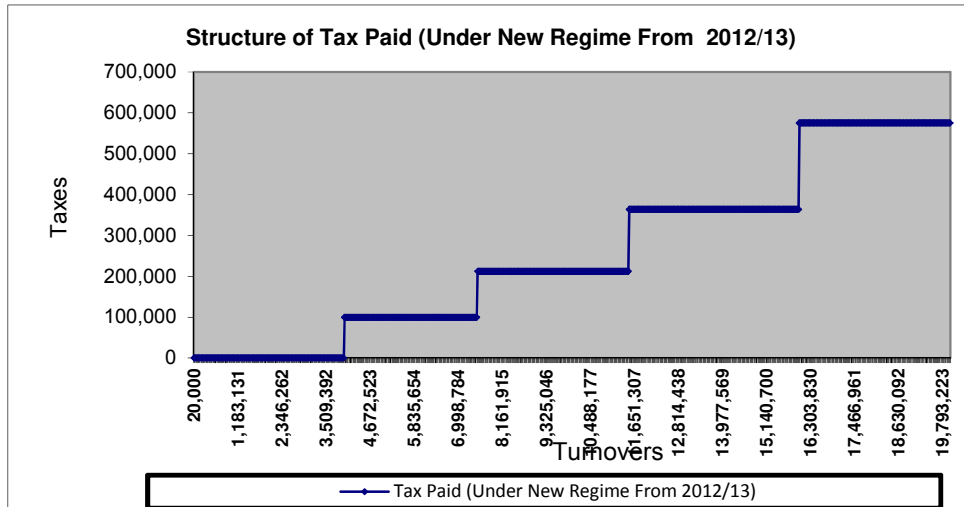


Figure 4: Structure of Tax Paid Under New Regime from 2012/13

Source: TRA Database 2014

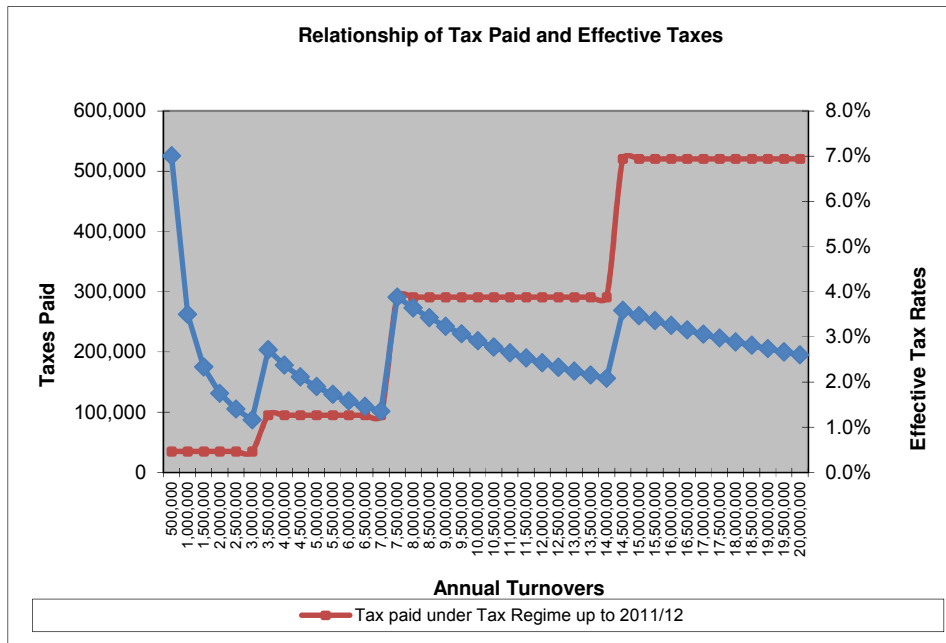


Figure 4.2: Effective Tax Rate of the Current Presumptive Tax Structure

Source: TRA informal Sector Study Data (2014)

Figure 5 also shows that the current presumptive tax structure punishes severely those with lower income turnovers within each band and taxes less those with higher turnovers within the same tax band.

### **6.2 Turnover-Based Presumptive Taxation**

Tanzania uses turnover-based presumptive taxation as an effective domestic finance resource policy instrument for reducing SME's compliance burden and bringing informal SMEs into the tax net. In this case, different SMEs segments are still treated uniformly; however, the tax rate increases according to the level of business turnover. The application of the presumptive system has been limited to small and medium scale businesses having difficulties in keeping formal or proper books and records. The study notes that the system has facilitated migration into the semi-standard tax system.

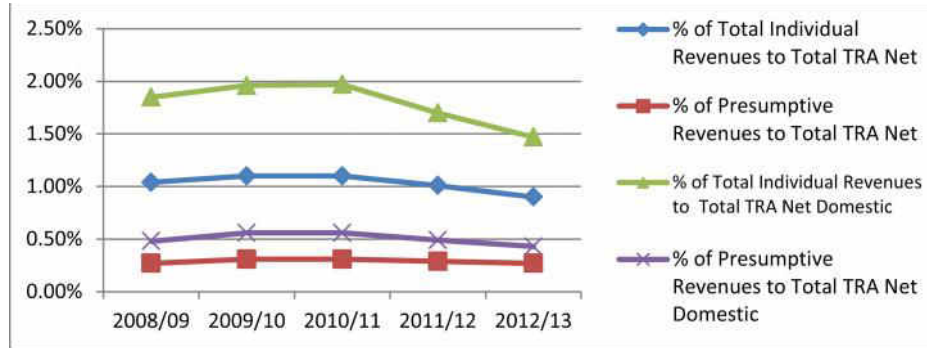
The progressive turnover-based presumptive taxation system has obliged small and medium scale businesses to keep at least some basic books and records without imposing any burdensome accounting requirements on SMEs operators. As a consequence of the requirement to observe basic bookkeeping standards, the transition from the presumptive to the standard tax regime is facilitated. The induced voluntary tax compliance behaviours in the small and medium scale enterprises are also advantageous in providing opportunities for financing, technical and supportive legal services (Plumley, 1996). As individuals and SME firms are required to maintain proper accounting documents, this serves to increase their visibility in the banking sector and demonstrate provable collateral and ability to repay debt.

Increased financing is critical to SMEs in the urban areas which are currently characterized as relatively highly undercapitalized (Ačevska, 2002). Financial resource infusion in these SME firms will lead to economic growth, improved labour productivity and product competitiveness. As a result, they will expand the tax base, providing increased revenues for fiscal expenditures and economic growth. For these reasons, there is fervent interest in the government and financial private sectors to improve access to capital to SME enterprises. Workers in these firms could be protected by decent wage laws and thereby increase their standard of living and improve the likelihood of advanced occupational training. Turnover has the potential of being a better proxy for profit estimation than indicators such as the size of business premises or the number of employees (Ahmed, & Braithwaite, 2005). However, the turnover-based system entails a risk of tax evasion due to under-declaration of business turnover.

### **6.3 Informal Sector Entrepreneur's Behaviour Not Changed**

Table 4 and Fig. 6 suggest that the presumptive income tax system has not been very effective and significant enough to change the behaviour of informal sector firms. The tables use four indicators to gauge effectiveness and significant effects. These are: (i) % of total individual—account and non-account case—revenues to total TRA net; (ii) % of presumptive revenues to total TRA net; (iii) % of total





**Figure 6: Indicators to Gauge Effectiveness and Significant Effects**

Source: TRA Data Files from the Research Unit

individual—account and non-account case—revenues to total TRA net domestic; and (ii) % of presumptive revenues to total TRA net domestic. These tax performance statistics show that the contribution of presumptive tax to total tax has been low and insignificant despite the tax reforms. This may suggest that many SMEs firms are still outside the TRA tax net; suggesting that these evade paying formal taxes (Allingham & Sandmo, 1972). Again, this may in turn imply that the size of the formal sector has not much changed relative to the size of the informal sector.

The primary disadvantages of taxing the micro, small and medium scale firms are costs of administration and enforcement, and horizontal and vertical inequity. Consultations with key informants suggest that there are other revenue collecting agencies such as local government authorities affecting the performances of SMEs. The tax administration in Tanzania is complex and has intertwining taxes. Further, the current central government and local government authorities are under fiscal pressure and confusion to search for more revenues. The government financing system is deteriorating due to increased unplanned government expenditures.

While the tax system is in reforms, there is no consensus on the sustainability of enforcing taxation in the micro and small scale informal economy (Ahmed, & Braithwaite, 2005). The present tax structure is politically charged and embroiled with a known environment of inefficiency and corruption. As a result, public sentiment towards tax compliance is relatively low in rural areas and much effort must be expended to alter these views and exact any substantial change. There are views of greater progress made towards improving the economy through first conversion of the informal sector, but the central and local government authorities must implement joint aggressive institutional reforms immediately.

## **7. Conclusion**

The current presumptive income tax is effective, i.e., rationalized and based on solid sector and fiscal policies foundations. In July 2004 the government provided a solid legal framework for the presumptive scheme by introducing a new simplified taxation schedule for small business taxpayers as part of a drive to make it easier for informal sector operators to register, formalize and start paying taxes. At the institutional level, the presumptive income tax is administered, managed and operationalized by the Department of Domestic Revenue and Block Management System in the TRA.

The paper suggests that presumptive tax system tolerates some aspects of informality. In many cases, and in practise, SMEs are classified as semi-formal or informal on the basis of their potential ability to comply with administrative procedures. Some of SME individual taxpayers are not legally registered or licensed by other government authorities, but are accepted as semi-formal business entities and taxable in this system.

One of the advantages of the turnover-based presumptive tax system is that it is easy to design. It also reduces the risks of disputes over the applicable tax rates and do not require complicated comparisons of profit margins in different small business segments. An implicit disadvantage feature of turnover-based systems is that they may result in a comparatively high tax burden for businesses with a comparatively low profit margin, and a relatively low tax burden for MSEs with very high profit margins. The presumptive income taxes for the first category have been high. This suggests that TRA has instituted tax incentives to encourage firms preparing and keeping formal accounts. However, the total presumptive income tax has been very small compared with other forms of income taxes, number of taxable entities and desired tax transformation targets.

Whereas some studies acknowledge that the absolute increase in tax revenues are partly due to the improvement of presumptive scheme system, this study also feels that other tax administrative measures have largely contributed to this achievement. These include the BMS, tax survey and patrols, tax severance and tax audits. There are also views that the presumptive income tax system has not been very effective and significant enough to change behaviour of informal sector firms. The contribution of presumptive tax to total tax has been low and insignificant despite the tax reforms. This may suggest that many SMEs are still outside the TRA tax net, suggesting the existence of disadvantages and weaknesses thereof.

The primary disadvantages to taxing micro, small and medium scale firms are costs of administration and enforcement, and horizontal and vertical inequity. The major areas of weakness such as an inefficient tax administration, an unfair and overly complex tax system for those in the tax network, and a disproportionately small tax base need to be addressed simultaneously.

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